ACCOUNTING

A Textbook for Class XI

Part I

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Foreword

One of the major thrusts of National Policy on Education (NPE) 1986 is to re-examine and update the content and processes of education and bring about qualitative improvement of school education. The Government of India has already initiated a number of steps in this direction. The National Council of Educational Research and Training (NCERT) has been assigned the responsibility of developing a new curriculum and related curricular materials in line with the new Education Policy to serve as a model for the States and Union Territories to adopt/adapt.

For the first time, the Council included Commerce, a much sought after subject among the students at the senior secondary stage of school education in its curriculum development programme. The Council set up an Advisory Board in Commerce under the Chairmanship of Professor P.K. Ghosh, formerly Professor of Commerce, Delhi University and Ex-Vice-Chancellor, North Bengal University to provide guidance for the development of curriculum in Commerce and Accountancy and to prepare instructional material in these two subjects.

On the advice of the Advisory Board, two Subject Committees were formed. Prof. L.S. Porwal, Professor of Commerce, Delhi University was appointed as the Chairman of the Subject Committee on Accountancy to develop a model textbook for Class XI. The Subject Committee on Accountancy consists of distinguished Accounting Experts from the Universities, professional institutions and NCERT. The draft of the textbook was prepared by Prof. L.S. Porwal, Prof B. Banerjee, Dr. N.K. Agrawal, Dr. Manmohan and Professor R.G. Saxena. It was then thoroughly discussed in two Workshops attended by practising teachers of schools, colleges and universities. Suggestions of the teachers were incorporated wherever necessary before finalising the manuscript.

I am thankful to Prof. L.S. Porwal, Chairman, Subject Committee on Accountancy who provided valuable guidance to his team of authors and finally edited this manuscript with Prof. R.G. Saxena.

I take this opportunity to thank all the members of the Subject Committee, who attended review workshops and provided valuable suggestions and comments at different stages for the improvement of the draft manuscript.

The preparation of curriculum textbook calls for considerable expertise and efforts in planning the work, screening, reviewing and editing the book and finally seeing it through the press. For all this, I am grateful to my colleague, Prof. R.G. Saxena, (Programme Incharge), Professor of Commerce in the Department of Education in Social Sciences and Humanities, who single handedly supervised the entire work right from the stage of curriculum development to bring the manuscript in the final shape and saw it through the press.

I must make a special mention of Prof. A.K. Jalaluddin, Joint Director, NCERT, who took lot of interest in this project and extended all possible help in bringing out this book. I also express my thanks to Shri C.N. Rao, Head, Publication Department and his publication team for making all efforts to bring out this in time.

Curriculum designing and development of instructional material is a highly challenging task It is an on-going process. No one can claim to have developed perfect curriculum or curriculum materials. There can always be some scope for further improvement. I, therefore, request all those who will be using this book to evaluate the material and offer valuable suggestions which would be taken into account while bringing out the revised version of the book.

P.L. MALHOTRA
Director
National Council of Educational
Research and Training

New Delhi

Preface

Over the last three to four decades, due to rapid advances in science and technology, business has grown at a fast pace. It has become complex. Accounting principles, practices, procedures and techniques have to be in tune with the economic and social development of a country in order to be able to perform the primary objective of accounting, i.e. useful reporting. During the past three decades in particular, there has been a 'revolution' in accounting theory and practice. Keeping in view the developments in accounting discipline, NCERT felt the need for a book on accounting for the senior secondary stage, which could incorporate, to the extent possible, the recent developments in the subject.

This book has been written by a team of knowledgeable, experienced and professional persons keeping the above objectives in view. The book has been written in a lucid, simple and easy-to-understand language so that a beginner in this subject can learn, assimilate and apply the different principles and techniques of accounting. The highlights of this book are:

- At the beginning of every chapter, *Learning Objectives* are listed. The student will know what he will learn after studying the chapter.
- At the end of the text of every chapter, *summary with reference to learning objectives* is given. This will enable the reader to recapitulate the main contents of the chapter.
- A list of *new terms introduced* is given at the end of a chapter In some cases, the terms have been explained there itself.
- *Conventional terms* are being replaced by *new terms* all over the world. Modern accounting literature uses *new terms*, which are now generally acceptable in all the countries. In order not to completely break away from the past, *conventional terms* have been used all over the text, but *new terms* have been also given in parenthesis. One cannot shut his eyes to modern developments. Attempt has been made in this book to slowly ushering in the modern era.
- Accounting literature has long given up the use of 'to', 'by' 'A/c' etc. in journal and ledger. Modern practice has been followed. This step in no way affects the quality of the book.
- The different chapters in this book have been written keeping in view the teaching hours alloted and the weightage assigned to each chapter.
- To test, information, understanding and application of a student, different types of graded questions—objective, short answer and essay-have been given at the end of every chapter. A *comprehensive* or *demonstration problem* with solution has been given where appropriate. Check list has also been given at the end of each chapter.
- The book has been planned to be covered in one academic session of two semesters. Part I covers the first semester course. The chapters in the book follow the sequence

given in the syllabus.

We are thankful to Shri R.C. Misra, Dr. Munish, Shri S.S. Sehrawat, Shri Sant Kishore Bansal, Miss Kanika Banerjee for their help in the development of the draft manuscript and joining review committee meetings.

We have spared no efforts to make the book useful to the students community and teachers whose response is of great value to us.

We look forward to the suggestions of the students and teachers for improving the text.

AUTHORS

GANDHIJI'S TALISMAN

"I will give you a talisman. Whenever you are in doubt or when the self becomes too much with you, apply the following test :

Recall the face of the poorest and the weakest man whom you may have seen and ask yourself if the step you contemplate is going to be of any use to him. Will he gain anything by it ? Will it restore him to a control over his own life and destiny ? In other words, will it lead to Swaraj for the hungry and spiritually starving millions ?

Then you will find your doubts and your self melting away."

mkGandhi

Contents

CHAPTER 1

INTRODUCTION TO ACCOUNTING

LEARNING OBJECTIVES

After studying this chapter, you should be able to :

* explain the meaning of accounting as an information system ;
* determine the users of accounting information ;
* distinguish between book keeping and accounting ;
* explain the objectives of accounting ;
* describe the role of accounting; and
* explain the meaning of the basic terms.

ACCOUNTING CAME INTO practice as an aid to human memory by maintaining a systematic record of business transactions. It was subsequently realized that accounting records, containing a wide range of information, have the potentialities of being used as the basis for decision making. This realization came due to the fact that accounting is capable of providing the kind of information that managers and other interested persons need in order to make better business decisions. For example, an investor would like to know whether the financial position of an enterprise is sound before deciding to put his money into it A manager would like to know which product has not been successful. On getting this information, he can decide either to stop producing it or take steps to make the product more appealing to customers. This aspect of accounting gradually assumed so much importance that it has now been raised to the level of an information system.

It is in this historical context of the evolution (development) of accounting that it provides a means of systematically recording and evaluating business activities. This is the primary reason for business (commerce) students, business executives and others to familiarize themselves with the accounting discipline.

1.1. MEANING OF ACCOUNTING

About 80 years ago, accounting was generally confined to the traditional record-keeping functions of the accountant. The role of the accountant has gradually changed from that of a mere recorder of transactions to that of a member of the decision making team. Accounting is now regarded as an information system.

In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as :

> the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part, at least, of a financial character, and interpreting the results thereof.

With greater economic development, the meaning of the term 'accounting' gradually became broader. In 1966, the American Accounting Association (AAA) defined accounting as :

> the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.

Further, in 1970, the Accounting Principles Board of AICPA stated:

> the function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.

Accounting can, therefore, be defined as :

> The process of identifying, measuring, recording and communicating the economic events of an organization to interested users of the information.

The above definition contains four essential characteristics of accounting :

1. Economic events,
2. Identification, measurement, record ing, and communication,
3. Organisation,
4. Interested users of information.

1.1.1 Economic Events

An economic event has been defined as ' a happening of consequence' to a business entity. Economic events are classified into external and internal types.

An external event which involves the transfer or exchange of something of value between two (or more) entities is called a transaction. The following are some examples of transactions :

(i) Sale of shoes by Bata Shoe Company to customers.

(ii) Rendering of services to customers by Weston Television Company.
(iii) Payment of wages to employees by Maruti Limited.
(iv) Payment of monthly rent to the landlord.
(v) Purchase of raw materials by an enterprise from some other business enterprise(s).

An **internal event** is an economic event that occurs entirely within one enterprise, e.g. supply of raw materials or equipment by the stores department to the manufacturing department.

1.1.2 Identification, Measurement, Recording and Communication

Identification . It means determining what to record, i.e to identify recordable events. It involves observing activities and selecting those events that are considered to be evidence of economic activity. Further, these events should be relevant to a particular business organization. The business transactions and other economic events are evaluated for appropriate accounting action. The value of human resources, changes in managerial policies or changes in personnel are important but none of these items is recorded in financial accounts. However, when a company makes a cash sale or purchase, even if the item is small, it is recorded in the books of account.

Measurement : It means quantification, including estimates of business transactions into financial terms, i.e. rupees and paise. If an event cannot be quantified in monetary terms, it is not considered for recording in financial accounts. This is why important items like the appointment of a new managing director, value of skilled employees or changes in personnel are not shown in the financial books.

Recording : Once the economic events are identified and measured in financial terms, they are recorded, i.e. a chronological diary of these measured events is kept in an orderly and systematic manner. An item should be depicted in both words and numbers with the amount included in the totals of the books of account. In recording, the accountant also classifies and summarizes these items.

Communication . The economic events are identified, measured and recorded in order that pertinent information is communicated in some form to management and others for internal and external uses. The information is communicated through the preparation and distribution of accounting reports The most common reports are in the form of financial statements (Balance Sheet and Profit and Loss Statement)

The Accounting Information System should be designed in such a way that the right information is communicated to the right person at the right time Reports can be daily, weekly, monthly or quarterly, depending upon the needs of the user. An important element in the communication process is the accountant's ability and responsibility to interpret the reported information. This is done by analysing and explaining the uses, meaning and limitations of reported data with the help of ratios, percentages etc.

1.1.3 Organisation

It can be a business entity or a non-business entity, depending upon the profit or non-profit motive.

1.1.4 Users of Accounting Information

Different categories of users need different kinds of information for making decisions. The users can be divided in two broad groups : (1) internal users; and (2) external users.

Internal users : These are the persons who manage the business, i.e. management at the top, middle, and lower levels. Their requirements of information are different because they make different types of decisions. The top level is more concerned with planning ; the middle level is concerned equally with planning and control; and the lower level is concerned more with

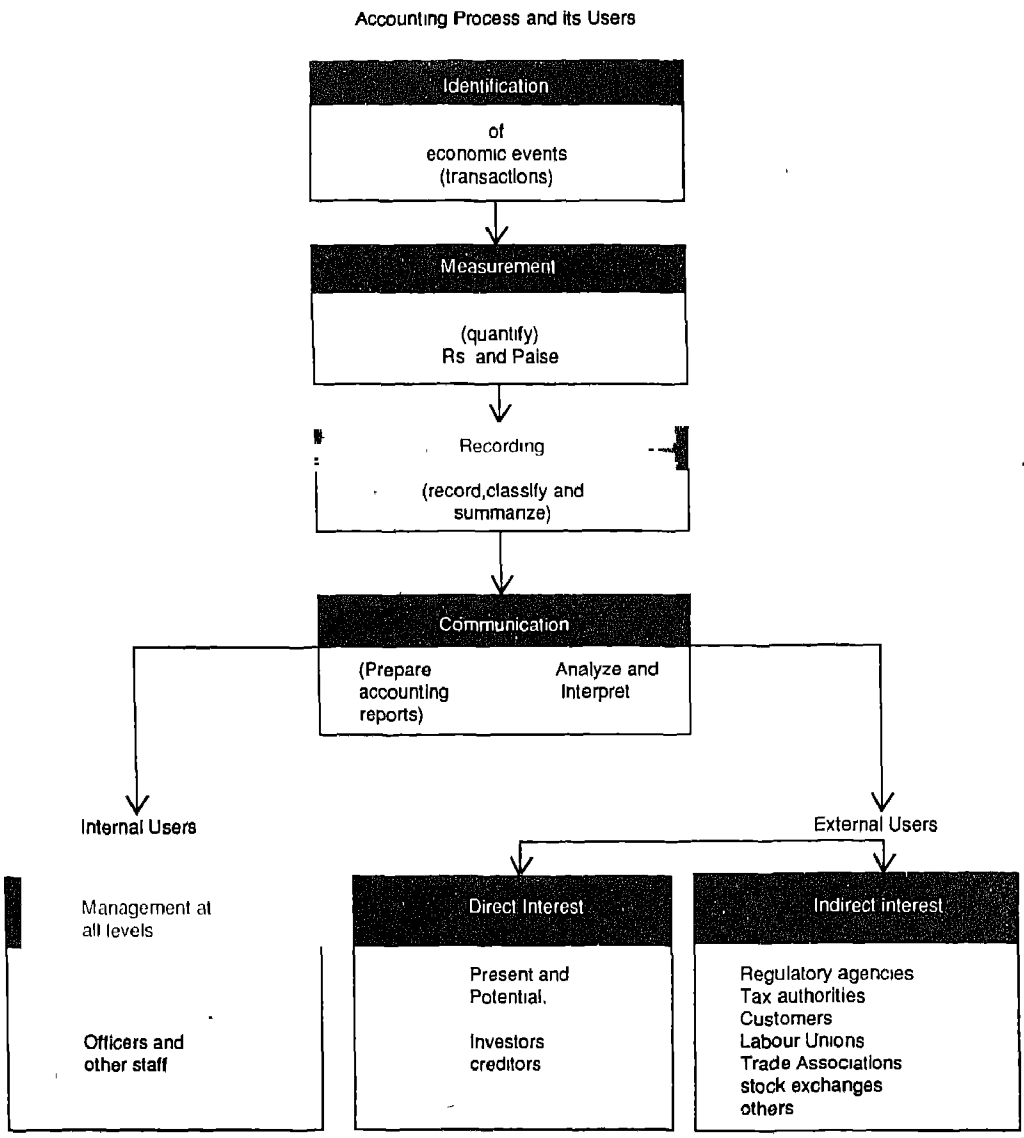

Figure 1.1 Accounting Process and its uses

controlling operations. Information is supplied on different aspects, e.g. cash resources, sales estimates, results of operations, financial position, sources and application of funds (see Figure 1.1.).

External users: All persons other than internal users (officers and staff concerned with decision making in a business organization) come in the group of external users. External users can be divided into two groups: (a) those having direct interest; and (b) those having indirect interest in a business organisation. The main sources of information for external users are annual reports of business organisations, which state the financial position and performance, and give the auditor's report, directors' report and other information.

(a) *External users having direct financial interest*: Investors and creditors—present and potential—are the external users having direct interest. Investors (owners), on the basis of quantitative information, decide about buying, holding or selling investments in a business entity. Creditors (banks, financial institutions, debenture holders and other lenders), evaluate the risk of granting credit or lending money to a particular business organisation on the basis of accounting information obtained about that organisation.

(b) *External users having indirect financial interest*: Tax authorities, regulatory agencies (such as the Department of Company Affairs, Registrar of Joint Stock Companies), customers, labour unions, trade associations, stock exchanges and others are indirectly interested in the company's financial strength, its ability to meet short-term and long-term obligations, its future earning power, etc. for making various decisions.

1.2 DIFFERENCE BETWEEN BOOK-KEEPING AND ACCOUNTING

Book-keeping usually involves only the recording of economic events (transactions) and is, therefore, just one part of the accounting process.

Accounting, on the other hand, involves the entire accounting process, i.e. identification, measurement, recording and communication of financial information. Nowadays, much of the book-keeping function is performed by machines.

1.3 OBJECTIVES OF ACCOUNTING

The basic objective of accounting is to provide information to the interested users to enable them to make business decisions. The necessary information, particularly in the case of external users, is provided in the following basic financial statements:

(i) Profit and Loss Statement, and

(ii) Balance Sheet.

Besides the above sources of information, the internal users, i.e. officers and staff of the enterprise, can obtain additional information from the records of business. Thus, the primary objectives of accounting can be stated as:

1. To maintain records of business.
2. Calculation of profit or loss.
3. Depiction of financial position.
4. To make information available to various groups and users.

1.3.1 Maintenance of Records of Business

There is an old saying— पहले लिख पीछे दे,
भूल पड़े तो कागज से ले ।

First record, then pay; if there is an error, trace it from the records. Human memory is short. Even the most brilliant executive or manager cannot accurately remember what he might have observed regarding the daily operations. He need not strain his memory unnecessarily, if proper and complete records of all business transactions are kept regularly. Moreover, records can be used by different officials for different decision making purposes.

1.3.2 Calculation of Profit or Loss

Earning profit is the main purpose for which a business is carried on. This information is available from the Profit and Loss Statement. Profit is calculated by deducting expenses from the asso-

ciated revenues. Profit is a measure of the performance of an enterprise.

1.3.3 Depiction of Financial Position

A Balance Sheet depicts the financial position of an enterprise. It is a statement of assets and liabilities. It shows the resources (assets) owned by an enterprise and depicts the claims (liabilities) against the resources. The balance of assets minus external liabilities shows the capital (owner's equity).

1.3.4 To Provide Information to Users

Internal users: The officers and staff of an enterprise need useful and timely information for making different types of business decisions. A major objective of accounting is to provide management with relevant and reliable information. For example, some of the questions a manager might ask are :

— How much profit did the company make during the last accounting period?
— Is the return to shareholders adequate? How can it be improved?
— Does the company have enough cash on hand to pay debts when they fall due? What are the projected cash needs in the next quarter?
— Which products are the most profitable?
— What is the cost of manufacturing each product?
— Which costs exceed the budget?
— How much money should be borrowed to expand the business?

External users : The outside users have limited authority, ability or resources to obtain information. Unlike internal users, they have to rely on financial statements (Balance Sheet, Profit and Loss Statement) as their principal source of information about an enterprise's economic activity. Primarily, the external users are interested in the following:

1. The amount and the time when they are likely to receive cash in future from dividend, interest and other sources.
2. Reliable information about economic resources (assets) and obligations (liabilities) of a business enterprise in order to evaluate its strength and weakness, and its financial position in general.
3. Information about the performance and earning power of a business enterprise.
4. Any other information relevant to the users' needs.

1.4 ROLE OF ACCOUNTING

Accounting is not an end in itself, it is a means to an end. It performs the service activity by providing quantitative financial information that helps the users in making better business decisions.

Accounting also describes and analyses a mass of data of an enterprise through measurement, classification and summarization, and reduces those data into reports and statements, which show the financial condition and results of operations of that enterprise.

Accounting as an information system collects and communicates economic information about an enterprise to a wide variety of interested parties.

1.5 BASIC TERMS

There are two basic financial statements which are prepared by an enterprise: (1) Balance Sheet; and (2) Trading and Profit and Loss Account (Statement).

The three components (elements) of a Balance Sheet can be stated in the form of the following basic accounting equation—

Assets = Liabilities + Capital (owner's equity)

Rs.50,000 = Rs.10,000 + Rs.40,000

This equation tells at a glance that the resources (assets) of this enterprise total Rs.50,000

; are being financed by two
)0 by the creditors (liabili-
utsiders' claims, and Rs.40,000
tal), also known as owner's

: resources of an enterprise
expressed in monetary terms.
value used by the business in
:xample, Super Bazar owns a
h is used by it for delivering
cks, thus, provide economic
erprise. This item will be
side of the Balance Sheet of

broadly classified into two
; and Current Assets.

e assets held on a long-term
, buildings, machinery, plant,
res. These assets are used for
ns of the business.

re assets held on a short-term
rs (accounts receivable), bills
eceivable), stock (inventory),
ble securities, cash and bank

ns or debts that the enterprise
y or services at some time in
herefore, represent creditors'
's assets. Both small and big
ecessary to borrow money at
her, and to purchase goods on
, for example, purchases goods
:redit for a month from Fast
npany on December 25, 1988.
:t of Super Bazar is prepared as
, 1988, Fast Food Products

Company will be shown as creditors (accounts payable) on the liabilities side of the Balance Sheet. If Super Bazar also takes a loan for a period of three years from Delhi State Co-operative Bank, this will also be shown as a liability in the Balance Sheet of Super Bazar.

Liabilities can be of the following types :

Long-term liabilities are those that are usually payable after a period of one year, for example, a term loan from a financial institution or debentures (bonds) issued by a company.

Short-term liabilities are obligations that are payable within a period of one year, for example, creditors (accounts payable), bills payable (notes payable), overdraft from a bank for a short period.

1.5.3 Capital

Investment by the owner for use in the firm is known as capital. From the accounting equation given earlier, it can easily be found that the capital is Rs.40,000. Owner's equity is the ownership claim on total assets. It is equal to total assets minus total liabilities.

1.5.4 Revenues

These are the amounts the business earns by selling its products or providing services to customers. Other titles and sources of revenue common to many businesses are: sales, fees, commission, interest, dividends, royalties, rent received, etc.

1.5.5 Expenses

These are costs incurred by a business in the process of earning revenue. Generally, expenses are measured by the cost of assets consumed or services used during an accounting period. The usual titles of expenses are: depreciation, rent, wages, salaries, interest, costs of heat, light and water, telephone etc.

1.5.6 Purchases

Purchases are total amount of goods procured by a business on credit and for cash, for use or sale. In a trading concern, purchases are made of merchandise for resale with or without processing. In a manufacturing concern, raw materials are purchased, processed further into finished goods and then sold Purchases may be cash purchases or credit purchases.

1.5.7 Sales

Sales are total revenues from goods or services sold or provided to customers. Sales may be cash sales or credit sales

1.5.8 Stock

Stock (inventory) is a measure of something on hand-goods, spares and other items—in a business. It is called **stock on hand.**

In a trading concern, the stock on hand is the amount of goods which have not been sold on the date on which the balance sheet is prepared This is also called **closing stock** (ending inventory).

In a manufacturing company, closing stock comprises raw materials, semi-finished goods and finished goods on hand on the closing date.

Similarly, **opening stock** (beginning inventory) is the amount of stock at the beginning of the accounting year

1.5.9 Debtors

Debtors (accounts receivable) are persons and/or other entities who owe to an enterprise an amount for receiving goods and services on credit The total amount standing against such persons and/or entities on the closing date, is shown in the Balance Sheet as **sundry debtors** (accounts receivable) on the asset side

1.5.10 Creditors

Creditors (accounts payable) are persons and/or other entities who have to be paid by an enterprise an amount for providing the enterprise goods and services on credit. The total amount standing to the favour of such persons and/or entities on the closing date, is shown in the Balance Sheet as **sundry creditors** (accounts payable) on the liability side.

SUMMARY WITH REFERENCE TO LEARNING OBJECTIVES

1. Meaning of accounting as an information system

Accounting as an information system is the process of identifying, measuring, recording and communicating the economic events of an organisation to interested users of the information.

2. Users of accounting information

Accounting plays a significant role in society by providing information to management at all levels and to those having a direct financial interest in the enterprise, such as present and potential investors and creditors. Accounting information is also important to those having indirect financial interest, such as regulatory agencies, tax authorities, customers, labour unions, trade associations, stock exchanges and others.

3. Difference between book-keeping and accounting

Book-keeping involves only the recording of business transactions, while accounting involves identifying, measuring, recording and communication of financial information.

4. Objectives of accounting

The primary objectives of accounting are to

(1) maintain records of business; (2) calculate profit or loss; (3) depict the financial position; and (4) make information available to various groups and users

5. Role of accounting

Accounting is not an end in itself It is a means to an end It plays the role of (1) providing service to the users, (2) describing, analyzing and reducing a mass of data into reports and statements that show the financial status and performance results of an enterprise; and (3) an accounting information system

6. Basic terms

Assets are the economic resources of an enterprise that can be usefully expressed in monetary terms

Liabilities are obligations or debts that an enterprise must pay in money or services at sometime in the future.

Capital is investment by the owner for use in the firm It is equal to total assets minus total liabilities.

Revenues are the amounts a business earns by selling its product or providing services to customers.

Expenses are the costs incurred by a business in the process of earning revenue

Purchases are the total amount of goods procured by business on credit and for cash, for use or sale.

Sales are total revenues from goods sold or services provided to customers.

Stock is a measure of something on hand—goods, spares and other items—in a business

Debtors (accounts receivable) are persons and/or other entities who owe to an enterprise an amount for receiving goods and services on credit.

Creditors (accounts payable) are persons and/or other entities who have to be paid by an enterprise an amount for providing the enterprise goods and services on credit.

EXERCISES

Short Answer Questions

1 Describe the steps in the accounting process
2 Explain the meaning of 'accounting'
3. Distinguish between 'book-keeping' and 'accounting'.
4. List the main objectives of accounting.
5. What is the primary reason for business students and others to familiarize themselves with the accounting discipline?
6. Which decision makers use accounting information?
7 What information do the users need?
8. Define assets, liabilities and capital
9. How will you define revenues and expenses?
10. What are the key components (elements) that form the content of a Balance Sheet?
11. Describe the role of accounting.

Objective Type Questions

12. Determine if the following are assets, liabilities, revenues or expenses or none of them · sales, debtors, purchases, creditors, salary paid to manager
13. Which of the following statements is not an objective of accounting?
(a) To provide information about the enterprise's assets, liabilities and capital.
(b) To provide information on the personal assets and liabilities of the owner of an enterprise.
(c) To maintain records of business.
(d) To information on the performance of an enterprise
14 The information provided in the annual financial statement of an enterprise pertains to :
(a) individual business enterprises.
(b) business industries.
(c) the economy as a whole
(d) none of the above
15. Do the following events represent business transactions?
(a) An employee is dismissed from his job.
(b) The owner of the business withdraws cash from the business for his personal use.
(c) Goods are purchased on credit.
(d) The owner of the firm dies.
(e) A prospective employee is interviewed.
(f) Goods are ordered for delivery next month.
(g) Land is purchased for cash.

Essay Type Questions

16. Define accounting and explain its characteristics.
17 Explain the primary objectives of accounting.

CHECK LIST OF KEY LETTERS/WORDS

Q.No.	Key	
13	b	
14	a	
15	(a)	No
	(b)	Yes
	(c)	Yes
	(d)	No
	(e)	No
	(f)	No
	(g)	Yes

CHAPTER 2

THEORY BASE OF ACCOUNTING

LEARNING OBJECTIVES

After studying this chapter, you should be able to :

* explain the meaning of generally accepted accounting principles (GAAP).
* identify the basic operating guidelines used by accountants;
* describe the basic assumptions of accounting;
* explain the basic accounting principles;
* identify and explain the modifying principles; and
* identify the major qualitative characteristics of accounting information.

HAVING LEARNT THE meaning and objectives of accounting in the preceding chapter, it is logical that some rules are set for preparing the financial statements. These rules are usually called **'generally accepted accounting principles'** (GAAP). The accounting profession has established a set of rules and practices that are recognized as a general guide for financial reporting purposes The GAAP are so called because they have been commonly accepted by the professional accounting world as general guidelines for preparing the financial statements and reports for external reporting For this, detailed operating guidelines are needed which can be classified into assumptions, principles and modifying principles (see Figure 2.1). These are the most fundamental principles of accounting, an understanding of which is necessary for any one who uses financial accounting data.

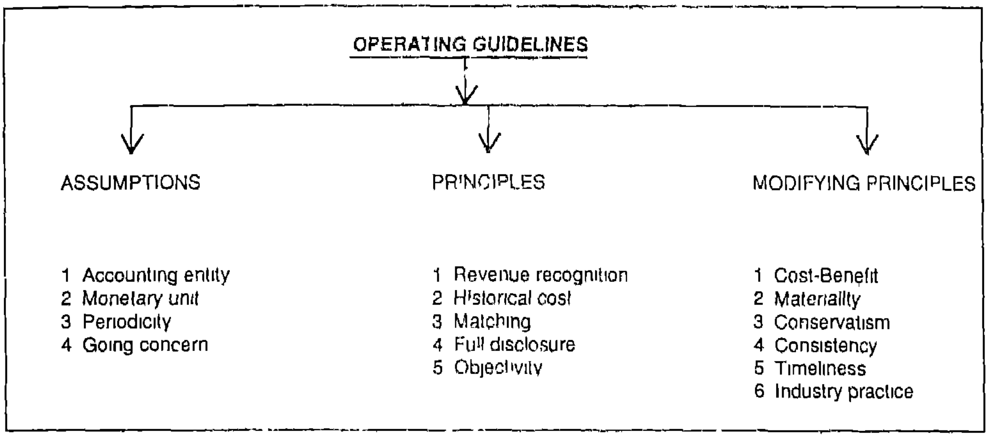

Figure 2.1 Operating guidelines

2.1 BASIC ASSUMPTIONS

Assumptions provide a foundation for the accounting process. There are four **basic assumptions—accounting entity, monetary unit, accounting period and going concern.** These four basic assumptions are like four pillars or columns on which the structure of accounting is built. No enterprise can prepare financial statements without considering these assumptions

2.1.1 Accounting Entity Assumption

The accounting entity assumption, also known as **Economic Entity Assumption, states that economic events can be identified with a particular unit of accountability.** This assumption requires that for accounting purposes, a business is treated as a **separate entity,** that is distinct from (1) its owner or owners; and (2) all other economic entities. It should have a completely separate set of records. Its Balance Sheet refers to its own financial affairs Under this assumption, a record of the personal effects of the owner should be kept separate, and not mingled with those of his business

For example, the owner's house, his investment in securities, his personal car, and personal income and expenditure should be kept separate from the accounts of his business entity. Also, if the owner has some other business entity, doing another business, its records should also be kept separate If this assumption is not followed, the financial status and operating results of a business entity cannot be known. The assumption is applicable to all forms of organisation —proprietorship, partnership or a company.

2.1.2 Monetary Unit Assumption

Also called **money measurement,** this assumption requires that **all business transactions will be recorded in terms of money,** i.e. rupees and paise in India. Only those transactions that are capable of being expressed in terms of money are included in the accounting records of the enterprise. This assumption is supported because the monetary unit is relevant, simple and understandable. By expressing all assets and liabilities in terms of money, the accountant creates a common measure that permits addition and substraction of all forms of assets and liabilities, and makes possible the preparation of financial statements Had there been no monetary unit assumption, it would have been difficult to record business transactions. Suppose, for example, that an enterprise, on a particular day, buys an office table, purchases 50 metres of cloth and gets 20 litres of petrol. How will the accountant record all these transactions? How will the office table, the metres and the litres be added? They are expressed in different units. To make accounting records relevant, simple, understandable and homogeneous, they are brought to a common unit of measurement, i.e. money.

It should, of course, be understood that information, which cannot be expressed in money terms, does not find a place in accounting records, e.g. the quality of service, the health of the owner or the morale of labour.

This **basic assumption** assumes that the unit of measure remains sufficiently stable over time. The purchasing power of the monetary unit does not fluctuate. If there are changes, of large magnitude in prices as has been the case in India and many other countries of the world during the past 20 years, the accounting period assumption loses much of its validity. This affects comparability of financial statements prepared in different years since accounting treats all rupees alike, whether it is a rupee of 1955 or a rupee of 1988. But at present, the assumption of stability is accepted by the accountants for practical reasons.

2.1.3 Accounting Period

This assumption is also known as **Periodicity Assumption** or **Time Period Assumption.** According to this assumption **the economic life of an enterprise is divided into arbitrary periods for preparing financial statements.**

This assumption would not be needed if the accountant could wait to prepare the financial statements of an enterprise till its termination or liquidation. But this is not a feasible proposition. No group of users—management, investors, creditors, and others—can wait indefinitely for such information In today's business environment, all enterprises deem it necessary to report the results of their operations more frequently.

As a financial, calendar or diwali year is of 12 months, the enterprises usually have a cutoff period every 12 months for reporting the results of their economic activities The three seasons—winter, summer and rainy—also recur after a period of 12 months. The Government also levies taxes on income on an annual basis. In spite of dividing the total life of an enterprise into segments based on annual time periods, the idea of accounting periods is quite useful.

Accounting time periods could be also a month or a quarter or half a year. Monthly, quarterly and half-yearly time periods are often referred to as **Interim Periods.** Reports for such shorter periods are called Interim Reports. **Interim Reports** are usually less reliable than annual reports, since the shorter the time period, the more difficult it becomes to determine the proper net income for the period. Many estimates have to be made because accurate data for many items for short time periods are not available. Yet, the quicker the information, even though less reliable, the more relevant it is for decision making. Timely information is more useful than delayed information.

2.1.4 Going Concern Assumption

The accountants prepare financial statements on the assumption that **a business will have an indefinite life unless it is likely to be sold or liquidated in the near future.** This is why it is also called the **continuity** assumption.

Most enterprises continue to operate profitably for indefinite periods. They are, in fact, going concerns. It is because of the going concern assumption that outside parties enter into long-term contracts with the enterprise. They give loans, purchase debentures (bonds) or invest their funds in marketable long-term securities. The going concern assumption allows one to defer costs, such as prepaid expenses, closing stock (ending inventories), that are to be charged against revenues of future periods. The depreciation on the fixed assets of an enterprise is charged on the assumption of continuity. The fixed assets are recorded at the acquisition cost, and carried in the Balance Sheet at actual cost less depreciation charge. The fixed assets, as at present, are not shown at their market value—simply because of the continuity assumption. Without this assumption, the classification of current and fixed assets and short-and long-term liabilities cannot be made, and labelling anything as fixed or long term would be difficult to justify. The justification for all the techniques of income measurement rests on the assumption of continuity.

2.2 BASIC PRINCIPLES OF ACCOUNTING

Basic accounting principles are **general decision rules which govern the development of accounting techniques.** On the basis of the four fundamental assumptions of accounting discussed above, the accounting profession has developed principles that guide how transactions should be recorded and reported. We shall discuss in the following pages the basic principles of accounting :

—Revenue Realization Principle
—Historical Cost Principle
—Matching Principle
—Full Disclosure Principle
—Objectivity Principle

2.2.1 Revenue Realization Principle

Also known as **Revenue Recognition Principle, this principle states that revenue is measured by the amount charged for goods sold or services rendered to customers.** The GAAP require that revenue should be recognized in the period in which the sale is deemed to have occurred. Revenue from services rendered is recognized when services have been performed to the satisfaction of the customer, and are billable (i.e., he becomes liable to pay).

Similarly, revenue from disposal of assets, other than products, is recognized at the date of sale. Revenue from permitting others to use enterprise assets, such as interest, rent and royalties, is recognized as time passes or as the assets are used. For example, monthly rent from a building given on rent is recognized as the month is over. Half-yearly interest on a loan given to a subsidiary company is recognized when the six-month period is over.

There are, however, exceptions to the sales basis for revenue recognition. (1) In some cases, revenue can be recognized at other points in the earning process, e.g. before the actual delivery of the product. In long-term construction projects, revenue is usually recognized before the completion of the contract. (2) In some circumstances, revenue recognition is postponed until cash has been received, even if the sale might have taken place. For example, sale by the instalment method. The cash basis is generally used when it is difficult to determine the revenue amount at the time of a credit sale because collection is not certain. There may be defaults in payment of some instalments.

But for these exceptions, revenue is recognized at the point of sale when title to the goods passes from the seller to the buyer, which is usually the date of delivery.

2.2.2 Cost Principle

This principle requires that all transactions should be recorded at their monetary cost of acquisition. Most assets and liabilities are recorded in the books of account at the cost of acquisition They are carried from year to year at acquisition cost, irrespective of any subsequent increase or decrease in their market value This is why this principle is also called the **Historical Cost Principle.** During a period of changing prices, one would like many assets to be shown at the current value in the financial statements. But cost has an important advantage over other valuations It is **reliable, definite and verifiable.** By using cost as the basis for recording transactions, the accountants can provide **objective** and **verifiable** data in their financial statements and reports.

2.2.3 Matching Principle

The matching principle holds that expenses should be recognized in the same period as associated revenues. Expense recognition is tied to revenue recognition. "Let the expense follow the revenue." This practice is called the matching principle since it "dictates that expenses be matched with revenues, whenever it is reasonable and practicable to do so".

The matching principle is very important for correct determination of profit (income), which is a measure of performance. In other words, only expense incurred in generating periodic revenues should be deducted from those revenues to derive the amount of periodic income.

It should be noted that "expenses are not recognized when cash is paid, or when the work is performed, or when the product is produced; they are recognized when the service or the product actually makes contribution to revenue". All expenses that will only generate revenues in the current accounting period are recognized as expenses associated with the current period. All **period costs,** i.e. expenses incurred in the period, should be recognized. **Cost of goods sold** during the period and **operating expenses** of the period are recognized as expenses Part of the cost of long-lived assets (depreciation) is also treated as expense for matching the expenses of the period with revenues of that period.

Proper matching of revenues and expenses is accomplished through the **accrual accounting** techniques, which will be discussed in subsequent chapters.

2.2.4 Full Disclosure Principle

The full disclosure principle requires that all facts necessary to make financial statements not misleading, must be disclosed. In other words, the full disclosure principle states that all information significant to the users of financial statements, should be disclosed. This can be done either in the financial statements or their foot notes. Such information may relate to the period covered by the financial statements or to post-Balance Sheet date. For instance, an enterprise has taken a big loan a fortnight after the date on which the Balance Sheet of the period just ended is to be prepared and presented. This will affect the financial status of the enterprise. Another instance could be a claim of a very big sum pending in a court of law against an enterprise. It should be brought to the notice of users, otherwise the statements would be misleading. Similarly, if there is a change in the accounting methods of providing depreciation on fixed assets, or in methods of valuation of stock (inventory) or in making provision for likely bad debts, it should be shown in the Balance Sheet by way of a foot note. There is demand for more and more disclosure of information by regulatory agencies to protect the interests of investors, creditors and others.

2.2.5 Objectivity Principle

While discussing the historical cost principle, it was stated that cost is definite and verifiable, while value is not Value may mean different things for different persons. **The principle of objectivity requires that accounting data should be verifiable and bias-free**, i e. free from the personal bias of the measurers In historical cost accounting, transactions that are recorded in the books of accounts are based on original documents, such as vouchers, invoices, receipts, etc The accounting entries are based on objectively determined evidence. They are, therefore, **verifiable.** Further, the users of financial statements should feel that the data they rely on are not subject to the bias of either management or the accountant who prepares the accounts. The accounting reports should not only be fair but also believed to be fair by the external users. There should be equitable treatment of all categories of users. Accounts should not be prepared favouring only one or two categories of users

In value-based accounting, there is likely to be great **subjectivity** because of different valuations of items by different valuers. Financial statements based on such valuations will neither be reliable nor objective That is why, historical cost accounting, in spite of having many shortcomings and limitations, has been preferred by professional accountants to other accounting systems based on value

2.3 MODIFYING PRINCIPLES

We have learnt by now the basic assumptions and basic principles, which provide a set of operating guidelines for preparing the financial statements However, the overriding consideration is that financial information should possess the qualitative characteristic of **usefulness** (See Figure 2.2) Information will be regarded as useful when it is relevant and **reliable.** Relevant information is that which provides a basis for **forecasting** future profits and cash flows and provides **feedback** on past performance Reliable information is that which can be **depended upon.** It is free from **error** and **bias**, and it is **faithfully represented**

The basic assumptions and basic principles as stated earlier, provide guidelines for the financial statements, in order to prepare theoretically correct statements But in practice, the financial statements are prepared after taking into consideration the ability of users to understand the details contained therein Due to certain constraints, these assumptions and principles have to be modified For instance, the cost-benefit relationship, materiality, consistency, conservatism, timeliness, industry practice and other considerations have to be taken into account for making the information useful. These modifying principles have been discussed in the following pages

MAJOR QUALITATIVE CHARACTERISTICS

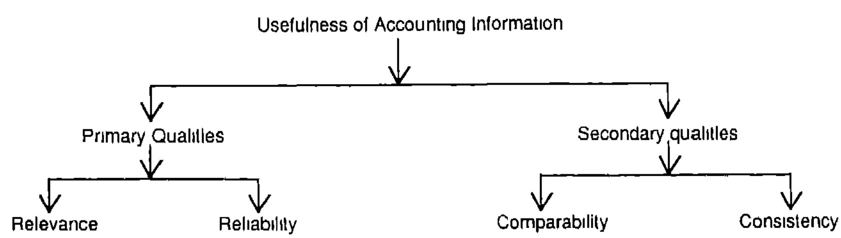

Figure 2 2 Major Qualitative Characteristic

2.3.1. Cost-Benefit Principle

The cost-benefit modifying principle (constraint) holds that **the cost of applying an accounting principle should not exceed its benefit.** In other words, the benefits to be gained from providing new accounting information should be greater than the costs of providing it. It does not mean that to save cost, no information or very little information only should be given to users. Certain minimum levels of relevance and reliability must be reached for accounting information to be useful.

It was, till recently, required by many developed countries that information about the effect of inflation on financial accounts should be reported to external users by way of supplementary statements to the main annual reports. This, no doubt, enhanced the cost of providing such information. Recent studies have shown that the benefit of providing such additional information was not more than the cost. Providing additional information has, therefore, been dropped.

Similarly, in India, information about those employees of a company whose annual remuneration exceeds Rs. 36,000, was to be given in the annual report. This enhanced the cost of providing information. Managements of companies appealed against providing this information on the plea that the cost of doing so was more than the benefit. The amount of Rs 36,000 has now been substituted by the words, "such sum per month as may be prescribed" in the Companies Act.

Cost-benefit analysis entails many difficulties. Cost can be of several kinds. It is more difficult to measure the benefits accruing to preparers and users.

2.3.2 Materiality Principle

The term **material** refers to the relative importance of an item or event. If an item or event is material, it is likely to be relevant to the user of the financial statements. It is likely to influence the decision of a reasonably prudent investor or creditor.

The full disclosure principle, as stated earlier, requires that all facts necessary to make financial statements not misleading must be disclosed. **The materiality principle is an exception or modifying principle.** It is due to this reason that items or events, having an insignificant economic effect, or not being relevant to the user, need not be disclosed.

The concept of materiality is relative. What is material for a small company, may not be material for a big company like Tata Electric Locomotive Company (TELCO) The cost of items such as small tools may be material for a small repair workshop, but the same figure may be immaterial for TELCO Limited Similarly, the nature of the transaction should also be considered. A difference of Rs. 1,000 in depreciation expense may be regarded as immaterial, but the difference of Rs. 1,000 in cash could be termed material.

Likewise, while a given series of transactions might **each** be considered immaterial, their aggregate effect could be quite material in certain circumstances. A few small errors might not be worth considering individually, but their total in an accounting period may be a material amount.

The essence of materiality can be stated in the following words :

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

Thus, when the amount is material, the operating guidelines should be followed However, if the item or event is immaterial, even in the

aggregate the application of a particular guideline is not necessary.

2.3.3 Consistency Principle

The consistency principle holds that unless otherwise disclosed, accounting statements should be prepared on the same basis as that of the preceding period. Information about an enterprise is more than useful if it is comparable with similar facts about the same enterprise over several accounting periods or about another enterprise(s) for the same accounting period. **Comparability** results when enterprises use the same accounting principles. For instance Maruti, Standard, Ambassador and Premier automobiles use the historical cost principle in reporting plant and machinery on the Balance Sheet. Further, each company uses the revenue recognition and matching principles in determining net profit (income).

Consistent use of accounting principles and procedures is necessary in achieving comparability. The **consistency principle** requires that a particular accounting procedure, once adopted, will not be changed from one accounting period to another unless the user is informed of the change.

The generally accepted accounting principles (GAAP) permit more than one method of describing identical operating situations. For example, two firms may adopt two different methods of providing depreciation on fixed assets or inventory valuation or making provision for likely bad debts, which are permissible under the GAAP. The result would be that the two firms will report different amounts for the same type of accounting transactions. This will make the two financial statements not comparable. Similarly, if a firm adopts different accounting procedures in two accounting periods, the results will not be comparable. This is why the consistency principle requires that the basis of preparing financial statements should remain consistent with the preceding accounting period The same accounting principles and methods should be adopted from year to year, within a firm. This principle does not allow changes at will from one accounting procedure to another.

This should not be taken to mean that the consistency principles does not allow a firm to change accounting methods and procedures under any circumstance. It allows the firm to change to another method of accounting in situations in which it can be shown that the newly adopted method is preferable to the old one or if the new method will result in more meaningful information.

However, the nature and effect of the change in the accounting method, and the justification for the change, must be disclosed in the financial statements of that year by way of foot notes to enable the users to be aware of the lack of consistency.

2.3.4 Conservatism Principle

This principle holds that **when more than one accounting or measurement alternative is permissible for a transaction, the one having the least favourable immediate effect on profits (net income) or capital (owner's equity) usually should be adopted.** In other words, the principle of conservatism requires that business transactions should be recorded in such a manner that profits are not overstated. To put it simply, it means that all anticipated losses should be recorded in the books of account, but all unrealized gains should be ignored. In effect, it means that when in doubt, choose the alternative that will be least likely to overstate the income and assets. In judging or estimating, the accountants are often faced with uncertainties or doubts. In such situations, they look to the principle of conservatism. For instance, a pending law suit by a firm may or may not be decided in its favour. The accountant, in such a case, would, most

likely, decide to make provision for this contingency in the books of account. Based on this principle, the stock on hand (ending inventory) or certain categories of investments are shown at 'lower of cost or market'.

Conservatism can be a useful tool in situations of uncertainty and doubt, but the abuse of this principle can definitely lead to incorrect and misleading statements. For instance, if the accountant incorrectly applied the principle of conservatism by charging the cost of the plant to the expense account in the period of purchase, the profit (income) and assets would be understated in the current period, and the profit would be overstated for the future periods. This principle nowhere urges the accountant to understate assets and revenues and overstate liabilities and expenses. This shows a generally pessimistic attitude on the part of the accountant.

Conservatism is now being replaced by **prudence.** In contrast to the earlier international understatements of assets and profit, the accountant now exercises prudence and applies the conservatism principle only in circumstances in which there is great uncertainty and doubt. The preference is that **any possible errors in measuring assets and profit should be in the direction of understatement rather than overstatement.** Under the principle of prudence, "profits are not anticipated but recognized only when realized, though not necessarily in cash".

2.3.5 Timeliness

Useful information is that which as stated earlier, is relevant and reliable. To be relevant the information must also be timely. If information is not available when it is needed or becomes available long after it loses value for future action, it is of little or no use. **Timeliness, therefore, means having information available to decision-makers before it loses its capacity to influence decisions.** If the Annual Report (Profit and Loss Statement, Balance Sheet and other reports) of an enterprise is made available to external users, say 11 or more months after the accounting period was over, it will not be regarded as timely. It will be of little use to the users. Similarly, if the quarterly (interim) report of the first quarter (January-March) of an enterprise is made available to the users at the end of the third quarter or the beginning of the fourth quarter, the information would not be very useful to the decision-makers. It cannot be called a timely report.

Old and late information hampers the ability of users to make rational decisions. Timeliness is a user constraint. It puts restrictions on the basic principles. Reliability is a primary quality to make information useful, but too much time is devoted to make information very reliable, it is likely to get late. It is better to have less reliable information which is timely rather than more reliable information which is late. In this way, timeliness is a modifying principle.

2.3.6 Industry Practice

Practical considerations, sometimes, require departure from the accounting guidelines discussed above. The unique characteristics or the peculiar nature of some industries and business concerns require the use of different accounting approaches and procedures to produce realistic financial reporting. For example, banks and insurance companies in some countries report certain investment securities at market (rather than lower of cost or market) because these securities are traded frequently. In some companies, stock (inventory) is valued at cost instead of 'lower of cost or market'. Similarly, in the agricultural industry, crops are often reported at market value because it is costly to develop accurate cost figures on individual crops.

2.4. DUAL ASPECT—THE BASIS OF ACCOUNTING

Every business is carried on to earn profit. Profit is added to the capital at the end of the accounting period. Capital can be computed by the following Balance Sheet equation :

Capital = Assets — Liabilities

or Assets = Liabilities + Capital

The equation is the **basis of accounting** or the **foundation of accounting.** (Some regard the dual aspect as a principle of accounting). Whenever any transaction takes place, it has to be recorded in two or more accounts to balance the equation. If one side of the equation is affected (increased or decreased) by a transaction, it will also affect (increase or decrease) the other side of the equation or increase one account and decrease another account on the same side. Then only can the Balance Sheet equation remain balanced This is known as the **dual aspect,** i.e. the two aspects of a transaction—one affecting one side, and the other affecting another. For example, a proprietor puts in Rs. 40,000 in cash and takes a Rs 10,000 loan from a bank, and these Rs. 50,000 are used in buying land and machinery. The two sides of the Balance Sheet equation will be shown as :

Assets = Liabilities + Capital

Rs. 50,000 = Rs. 10,000+ Rs. 40,000

Both liabilities and capital have been shown on one side of the equation. Rs 10,000, being a loan from the bank (an outsider to the entity), is regarded as the **external liability** and Rs 40,000, being the amount of capital put in by the proprietor, is regarded as the **internal liability.**

Whenever a further transaction takes place, it will affect the two accounts to keep the equation balanced. For example, if an individual asset is increased, there must be a corresponding .

1. decrease in another asset; or
2. increase in a specific liability; or
3. increase in capital (owner's equity).

The reverse is also true. The dual aspect, thus, affects two accounts for a simple transaction

More about this can be learnt in the next chapter.

SUMMARY WITH REFERENCE TO LEARNING OBJECTIVES

1. Meaning of generally accepted accounting principles (GAAP)

The generally accepted accounting principles (GAAP) are a set of rules and practices that are recognized as a general guide for financial reporting purposes

2. Operating guidelines used by accountants

These operating guidelines are basic assumptions, basic accounting principles and modifying principles. These guidelines are well-established and accepted in accounting

3. Basic assumptions of accounting

Assumptions provide a foundation for the accounting process. There are four basic assumptions. accounting entity, monetary unit, accounting period, and going concern.

Accounting entity : This assumption requires that for accounting purposes, a business is treated as a separate entity, i.e. distinct from (1) its owner/owners, and (2) all other economic entities.

Monetary unit : This assumption requires that all business transactions will be recorded in terms of money Those transactions that are not capable of being recorded in terms of money are excluded from accounting records.

Accounting period · This assumption permits the economic life of an entity to be divided into arbitrary periods, usually 12-month periods, to report on the performance and financial position of a concern to its users periodically

Going concern : This assumption states that a business will have an indefinite life unless it is likely to be sold or liquidated in the near future.

4. Basic accounting principles

Revenue realization · Revenue should be recognized in the period in which the sale is deemed to have occurred There are some exceptions to sales basis of revenue recognition.

Cost principle · Requires that all transactions should be recorded at their monetary cost of acquisition All assets and liabilities are carried in the books of account at historical (acquisition) cost, irrespective of any subsequent increase/decrease in their market value.

Matching : This principle holds that expenses should be recognized in the same period as associated revenues Expense recognition is tied to revenue recognition. Let the expenses follow the revenue.

Full disclosure . All facts necessary to make financial statements not misleading must be disclosed

Objectivity · The acoounting data should be definite, verifiable and free from the personal bias of the measurers.

5. Modifying principles

Because of practical considerations and the limited ability of the users to understand the details contained in the financial statements, the principles discussed above, though theoretically desirable, have to be modified in practice These modifying principles are . cost-benefit, materiality, consistency, conservatism, timeliness and industry practice.

The cost-benefit principle : holds that the cost of applying an accounting principle should not be more than its benefit. If the cost is more, that principle is modified.

The materiality principle : states that items having insignificant economic effect or not being relevant to the users need not be disclose. If the item is likely to influence the decision of a reasonably prudent investor or creditor, it should be regarded as material, and shown in the financial statements.

The consistency principle : holds that unless otherwise disclosed financial statements and reports should be prepared on a basis consistent with the preceeding period. Comparability results when

the same accounting principles are consistently being applied by different enterprises for the period under comparison, or the same firm for a number of periods

The conservatism principle : requires that business transactions should be recorded in such a manner that profits are not overstated. All anticipated losses should be accounted for but all unrealized gains should be ignored. When in doubt, choose the solution that will be least likely to overstate income and assets.

Prudence : requires that the conservatism principle should be applied only in circumstances in which great uncertainty and doubts exist.

Timeliness : means having information available to decision-makers before it loses its capacity to influence decisions, even if it is less reliable

Industry practice : The unique characteristics or the peculiar nature of some industries and business concerns require the use of different accounting approaches and procedures to produce realistic financial reporting.

6. Major qualitative characteristics of accounting information

The two primary qualities of accounting information are relevance and reliability, and the two secondary qualities are consistency and comparability

TERMS INTRODUCED IN THE CHAPTER

Accounting entity	Full disclosure	Objectivity
Accounting period	Generally accepted	Operating guidelines
Basic assumptions	accounting principles (GAAP)	Prudence
Basic principles	Going concern	Qualitative characteristics
Comparability	Historical cost	Reliability
Conservatism	Matching	Relevance
Consistency	Materiality	Revenue realisation
Cost-benefit	Monetary unit	Timeliness
Dual aspect	Modifying principles	

EXERCISES

Short Answer Questions

1. **Why do accounting principles emphasize the use of historical cost as a basis for measuring assets?**
2. **What is the difference between comparability and consistency?**

3 Why is it necessary for accountants to assume that an economic entity will remain a going concern?

4. When should revenue be recognized ? Are there exceptions to the general rule?

5. Describe the following modifying principles
   (a) cost-benefit (b) materiality

6 What is the economic entity assumption?

7 What is the monetary unit assumption? Does it hold good when the prices are not stable? Give reasons for your answer.

8. Why is the periodicity assumption necessary for preparing the financial statements?

9. What is the basic accounting equation?

10. What is the matching principle ? Why should a business concern follow this principle?

11. Name the four basic assumptions that underlie the financial accounting structure.

12. Briefly describe the two primary qualities of useful accounting information

Objective Type Questions

13. During the life-time of an entity, accountants produce financial statements at arbitrary points in time in accordance with which basic accounting principle?
    (a) Cost - benefit
    (b) Periodicity
    (c) Conservatism
    (d) Matching
    (e) None of the above

14. The accounting principle that refers to the tendency of accountants to resolve uncertainty and doubt in favour of understating assets and revenues and overstating liabilities and expenses, is known as :
    (a) conservatism
    (b) materiality
    (c) industry practice
    (d) consistency
    (e) none of the above.

15. Revenue is generally recognized at the point of sale. Which principle is applied herein?
    (a) Consistency
    (b) Matching
    (c) Revenue realization
    (d) Cost principle
    (e) None of the above.

16. When information about two different enterprises has been prepared and presented in a similar manner, the information exhibits the characteristic of :
    (a) relevance
    (b) reliability
    (c) consistency
    (d) verifiability
    (e) none of the above.

17 The assumption that a business enterprise will not be sold or liquidated in the near future is known as the :
   (a) economic entity
   (b) monetary unit
   (c) conservatism
   (d) periodicity
   (e) none of the above.

18. The primary qualities that make accounting information useful for decision-making are:
   (a) comparability and consistency
   (b) materiality and timeliness
   (c) relevance and freedom from bias
   (d) reliability and comparability
   (e) none of the above.

19. Fill in the blanks below with the accounting principle, assumption or related item that best completes each sentence.
   (a) Companies must prepare financial statements at least yearly due to the ________ assumption.
   (b) ________ and ________ are the two primary qualities that make accounting information useful for decision-making
   (c) The ________ principle requires that the same accounting methods should be used from one accounting period to the next.
   (d) Recognition of expenses in the same period as associated revenues is known as the ________ principle.

Essay Type Questions

20 Describe the basic assumptions' of accounting

21. Explain the 'basic accounting principles'

22 Identify and explain 'the modifying principles'.

CHECK - LIST OF KEY LETTERS/WORDS

Q. No.	Key
13	b
14	a
15	c
16	e (comparability)
17	e (going concern)
18	e (relevance and reliability)
19	(a) Periodicity
	(b) Relevance and reliability
	(c) Consistency
	(d) Matching

CHAPTER 3

ORIGIN AND RECORDING OF TRANSACTIONS

LEARNING OBJECTIVES

After studying this chapter, you should be able to :

* explain the meaning of source documents;
* explain and compute the accounting equation;
* apply the rules of debit and credit;
* describe double entry book-keeping;
* explain the meaning and format of books of original entry and record entries therein;
* explain the meaning of ledger, make posting and balance the accounts ; and
* explain the meaning, need and importance of the bank reconciliation statement and prepare it.

THE FIRST STAGE in the accounting process is recording of transactions in the books of account. This Chapter begins with the introduction of the meaning of source documents (origin of a transaction) and then discusses the recording of transactions in various books of account

3.1 SOURCE DOCUMENTS

Documents on the basis of which entries/transactions are recorded in the books of account are known as source documents. They provide information about the nature of the transaction and the amount involved in it. The correctness of the recorded transactions can be verified with the help of source documents. The verifiable objective principle of accounting requires that each recorded transaction/event in the books of account should have adequate evidence to support it. Various business documents such as vouchers, invoices, bills, cash memos, receipts, constitute source documents. These documents provide written evidence of a transaction/event that has taken place. Source documents are also prepared for recording internal events such as depreciation and issue of materials from stores. Thus, there must be a source document for each entry recorded in the books of account.

The source document is the origin of a transaction and it initiates the accounting process, whose starting point is the accounting equation.

3.2 ACCOUNTING EQUATION

3.2.1 Meaning

Accounting equation is a statement of equality between the debits and credits It signifies that the assets of a business are always equal to the total of liabilities and capital (owner's equity). When this relationship is shown in the equation form, it is known as 'Accounting Equation' Thus,

$$A = L + C$$

Where, A = Assets
L = Liabilities, and
C = Capital

The above equation can be written in the following forms also,

$$A - L = C$$
$$A - C = L \text{ and}$$
$$A - C - L = \text{Zero}$$

Since the accounting equation depicts the fundamental relationship among the components of the Balance Sheet, it is also called the Balance Sheet Equation. As the name indicates, the Balance Sheet is a statement of the owner's equity, liabilities and assets. The owner's equity represents paid-in capital and accumulated profit (earned surplus).

An example of the simple Balance Sheet in T term is given below.

XYZ

BALANCE SHEET OF X AS ON —

Owner's Equity and Liabilities	*Amount* Rs	*Assets*	*Amount* Rs
Capital	50,000	Fixed assets	1,00,000
Accumulated profit	25,000	Current Assets	50,000
Loans	50,000		
Current Liabilities	25,000		
	1,50,000		1,50,000

In the above Balance Sheet, capital plus accumulated profit represent owners' equity; loans and current liabilities represent liabilities. All these taken together are equal to the assets. (Total of fixed assets plus current assets).

3.2.2 Computation

An external event that affects assets, liabilities or capital (proprietorship) is called a transaction. All transactions are recorded in the books of

account in a chronological order. Before a transaction is recorded, it is analysed to ascertain which account is to be debited and which account is to be credited.

The transactions analysis is based on the manner a transaction affects assets, liabilities or capital. The analysis must always conform to the aforesaid accounting equation. At the time of recording every transaction, this test of equality is always kept in mind. It can be tested by drawing up a Balance Sheet after any or every transaction. Thus, all transactions can be expressed in terms of the accounting equation, (A = L + C).

We illustrate below transactions analysis by assuming certain transactions of X firm for the month of April, 1988:

Transaction 1

On April 1, X starts business and invests Rs 50,000 as his capital. This transaction, in terms of the Balance Sheet equation, will be shown as below.

Assets		=	*Liabilities*	+	*Owner's equity*
	Cash (Rs)	=	0 (Rs)	+	X's Capital
EFFECT OF TRANSACTION 1:-	+ 50,000			+	50,000
NEW BALANCE	50,000	=	0	+	50,000

Transaction 2

On April 1, the firm purchases furniture (fixed assets) for Rs 12,000, for cash. This reduces a current asset (cash) and increases a fixed asset (furniture) of the firm as shown below.

Assets			=	*Liabilities*	+	*Owner's equity*
	Cash (Rs)	+ Furniture (Rs)	=	0	+	X's Capital (Rs)
OLD BALANCE	50,000		=	0	+	50,000
EFFECT OF TRANSACTION 2:-	-12,000	+ 12,000	=	0		
NEW BALANCE	38,000	+ 12,000			+	50,000

Transaction 3

On April 2, the firm purchases merchandise (goods) costing Rs 24,000, for cash. This reduces current asset (cash) and increases another current asset (Merchandise) as shown below:

	Assets					=	*Liabilities*	+	*Owner's equity*
	Cash (Rs.)	+	Merchandise (Rs)	+	Furniture (Rs.)	=		+	X's capital (Rs.)
OLD BALANCE	38,000			+	12,000		0	+	50,000
EFFECT OF TRANSACTION 3	24,000	+	24,000						
NEW BALANCE	14,000	+	24,000	+	12,000	=	0	+	50,000

Transaction 4

On April 5, the firm purchases merchandise costing Rs. 40,000, on credit from Shripat This increases assets and also creates a liability as detailed below

	Assets			=	Liabilities	+	Owner's equity
	Cash (Rs.)	+ Merchandise (Rs)	+ Furniture (Rs)	=	Creditors (Rs)	+	X's Capital (Rs)
OLD BALANCE	14,000	+ 24,000	+ 12,000		0	+	50,000
EFFECT OF TRANSACTION 4		+ 40,000		=	+ 40,000		
NEW BALANCE	14,000	+ 64,000	+ 12,000	=	40,000	+	50,000

Transaction 5

On April 5, the firm sells merchandise for Rs 10,400, on credit to Shyam Lal, costing Rs. 7,280. This transaction is analysed in two steps

Step 1—Sale of goods on credit creates debtors, an asset representing the right of the firm to collect money from customers. This asset, considered by itself, increases the owner's equity as given below.

	Assets				=	Liabilities	+ Owner's equity
	Cash (Rs)	+ Debtors (Rs)	+ Merchandise (Rs)	+ Furniture (Rs)	=	Creditors (Rs)	+ X's Capital (Rs)
OLD BALANCE	14,000	+ 0	+ 64,000	+ 12,000	=	40,000	+ 50,000
EFFECT OF TRANSACTION 5. Step 1 (Recording Debtors)		10,400			=		+ 10,400
	14,000	+ 10,400	+ 64,000	+ 12,000	=	40,000	+ 60,400

Step 2· Sales require handing over of merchandise to customers. Since the cost of the above merchandise is Rs. 7,280, the asset (merchandise) stands reduced by this amount. The delivery of merchandise to the customer, considered by itself, reduces the owner's equity When this is considered, the above equation will become as under

	Assets							*= Liabilities*		*+ Owner's equity*
	Cash (Rs.)	+	*Debtors* (Rs.)	+	*Merchandise* (Rs)	+	*Furniture* (Rs.)	= *Creditors* (Rs)	+	*X's Capital* (Rs)
	14,000	+	10,400	+	64,000	+	12,000	= 40,000	+	60,400
EFFECT OF TRANSACTION 5.(Step 2) (Delivery of Merchandise)				-	7,280			=		-7,280
NEW BALANCE	14,000	+	10,400	+	56,720	+	12,000	= 40,000	+	53,120

Thus, the net effect of transaction 5 is an increase in the owner's equity by Rs. 3,120, being the margin of profit on sale (Rs.10,400 — Rs. 7,280)

Alternatively, transaction No 5 can also be analysed in one step as under:

	Assets							*= Liabilities*	*+*	*Owner's equity*
	Cash (Rs)	+	Debtors (Rs.)	+	Merchandise (Rs)	+	Furniture (Rs)	= Creditors (Rs.)	+	X's Capital (Rs)
OLD BALANCE	14,000	+	0	+	64,000	+	12,000	= 40,000	+	50,000
EFFECT OF TRANSACTION 5			+10,400		-7,280					+3,120
NEW BALANCE	14,000	+	10,400	+	56,720	+	12,000	= 40,000	+	53,120

Transaction 6

On April 10, the customer (Shyamlal) pays Rs. 4,800 on his account. This increases one asset (cash) and reduces another asset (debtors) as given below.

	Assets							*= Liabilities*	*+*	*Owner's equity*
	Cash (Rs)	+	Debtors (Rs)	+	Merchandise (Rs)	+	Furniture (Rs)	= Creditors (Rs.)	+	X's Capital (Rs)
OLD BALANCE	14,000	+	10,400	+	56,720	+	12,000	= 40 000	+	53,120
EFFECT OF TRANSACTION6.	+4,800		-4,800							
NEW BALANCE	18,800	+	5,600	+	56,720	+	12,000	= 40,000	+	53,120

Transaction 7

On April 12, the firm sells merchandise for Rs. 5,200 for cash, costing Rs. 3640. As explained in the case of transaction 5, this transaction may also be analysed in two steps.

Step 1: Sale of goods for cash increases an asset (cash) and, considered by itself, increases owner's equity as given below in the table.

	Assets							= Liabilities	+ Owner's equity
	Cash (Rs)	+	Debtors (Rs)	+	Merchandise (Rs)	+	Furniture (Rs)	= Creditors (Rs)	+ X's Capital (Rs)
OLD BALANCE	18,800	+	5,600	+	56,720	+	12,000	= 40,000	+ 53,120
EFFECT OF TRANSACTION.	+5,200								+5,200
	24,000	+	5,600	+	56,720	+	12,000	= 40,000	+ 58,320

Step 2 · The delivery of merchandise to the customer considered by itself, reduces both merchandise and owner's equity by Rs. 3,640 Thus, the above equation will be .

	Assets							= Liabilities	+ Owner's equity
	Cash (Rs)	+	Debtors (Rs.)	+	Merchandise (Rs.)	+	Furniture (Rs)	= Creditors (Rs)	+ X's Capital (Rs)
	24,000	+	5,600	+	56,720	+	12,000	= 40,000	+ 58,320
ON DELIVERY OF MERCHANDISE					-3,640				-3,640
NEW BALANCE	24,000	+	5,600	+	53,080	+	12,000	= 40,000	+ 54,680

If transaction 7 is alternatively analysed in one step, the equation will be as under.

	Assets							= Liabilities	+ Owner's equity
	Cash (Rs.)	+	Debtors (Rs.)	+	Merchandise (Rs.)	+	Furniture (Rs.)	= Creditors (Rs.)	+ X's Capital (Rs)
OLD BALANCE	18,800	+	5,600	+	56,720	+	12,000	= 40,000	+ 53,120
EFFECT OF TRANSACTION 7	+5,200	+			-3,640				-1,560
NEW BALANCE	24,000	+	5,600	+	53,080	+	12,000	= 40,000	+ 54,680

Transaction 8

On April 20, the firm pays to its creditor, Sripat, Rs 12,000 on account This payment reduces cash and also the liability as shown below in the table.

	Assets							= Liabilities	+ Owner's equity
	Cash (Rs)	+	Debtors (Rs)	+	Merchandise (Rs.)	+	Furniture (Rs.)	= Creditors (Rs)	+ X's Capital (Rs)
OLD BALANCE	24,000	+	5,600	+	53,080	+	12,000	= 40,000	+ 54,680
EFFECT OF TRANSACTION 8:	-12,000							-12,000	
NEW BALANCE	12,000	+	5,600	+	53,080	+	12,000	= 28,000	+ 54,680

Transaction 9

On April 24, Mr X withdraws Rs 500 for his personal use. This reduces cash and also Mr. X's equity as shown below·

	Assets							=	*Liabilities*	+	*Owner's equity*
	Cash (Rs)	+	Debtors (Rs)	+	Merchandise (Rs)	+	Furniture (Rs)	=	Creditors (Rs)	+	X's Capital (Rs.)
OLD BALANCE	12,000	+	5,600	+	53,080	+	12,000	=	28,000	+	54,680
EFFECT OF TRANSACTION 9	- 500										- 500
NEW BALANCE	11,500	+	5,600	+	53,080	+	12,000	=	28,000	+	54,180

Transaction 10

On April 25, Mr X brings further capital of Rs. 10,000 in the business. This transaction increases both cash and owner's equity as given below

	Assets							=	*Liabilities*	+	*Owner's equity*
	Cash (Rs)	+	Debtors (Rs.)	+	Merchandise (Rs)	+	Furniture (Rs)	=	Creditors (Rs)	+	X's Capital (Rs)
OLD BALANCE	11,500	+	5,600	+	53,080	+	12,000	=	28,000	+	54,180
EFFECT OF TRANSACTION 10	+ 10,000								+ 10,000		
NEW BALANCE	21,500	+	5,600	+	53,080	+	12,000	=	28,000	+	64,180

Transaction 11

On April 25, the firm pays Rs. 16,000 on account to its creditor, Sripat This payment reduces both an asset (cash) and a liability (creditor) as detailed below in the table.

	Assets							=	*Liabilities*	+	*Owner's equity*
	Cash (Rs.)	+	Debtors (Rs)	+	Merchandise (Rs)	+	Furniture (Rs)	=	Creditors (Rs)	+	X's Capital (Rs.)
OLD BALANCE	21,500	+	5,600	+	53,080	+	12,000	=	28,000	+	64,180
EFFECT OF TRANSACTION 11	–16,000								– 16,000		
NEW BALANCE	5,500	+	5,600	+	53,080	+	12,000	=	12,000	+	64,180

Transaction 12

On April 26, miscellaneous expenses amounting to Rs. 250 are paid. This reduces cash and also X's equity as given below:

	Assets							=	Liabilities	+	Owner's equity
	Cash (Rs)	+	Debtors (Rs)	+	Merchandise (Rs)	+	Furniture (Rs)	=	Creditors (Rs)	+	X's Capital (Rs.)
OLD BALANCE	5,500	+	5,600	+	53,080	+	12,000	=	12,000	+	64,180
EFFECT OF TRANSACTION 12	−250										−250
NEW BALANCE	5,250	+	5,600	+	53,080	+	12,000	=	12,000	+	63,930

Transaction 13

On April 30, rent amounting to Rs 520 has become due but has not been paid This is a liability of the firm and must be recorded It reduces owner's equity as detailed below·

	Assets							=	Liabilities +		Owner's equity
	Cash (Rs)	+	Debtors (Rs)	+	Merchandise (Rs)	+	Furniture (Rs)	=	Creditors + (Rs)	Rent + payable (Rs)	X's Capital (Rs)
OLD BALANCE	5,250	+	5,600	+	53,080	+	12,000	=	12,000	+ 0	+63,930
EFFECT OF TRANSACTION 13:										+520	- 520
NEW BALANCE	5,250	+	5,600	+	53,080	+	12,000	=	12,000	+520	+63,410

Transaction 14

On April 30, an assistant employed by Mr. X is paid his monthly salary of Rs. 1,200. This is an expense and reduces cash and also Mr. X's equity in the firm as under.

	Assets							=	Liabilities +		Owner's equity
	Cash (Rs.)	+	Debtors (Rs)	+	Merchandise (Rs.)	+	Furniture (Rs.)	=	Creditors + (Rs)	Rent + payable (Rs.)	X's Capital (Rs)
OLD BALANCE	5,250	+	5,600	+	53,080	+	12,000	=	12,000 +	520 +	63,410
EFFECT OF TRANSACTION 14:	- 1,200										- 1,200
NEW BALANCE	4,050	+	5,600	+	53,080	+	12,000	=	12,000 +	520 +	62,210

Transaction 15

On April 30, the firm charges depreciation of Rs 100 on furniture This reduces the value of furniture and alo X's equity as shown below

	Assets							=	*Liabilities*	+	*Owner's equity*
	Cash (Rs.)	+	Debtors (Rs)	+	Merchandise (Rs)	+	Furniture (Rs.)	=	Creditors (Rs)	+ Rent Payable (Rs)	+ X's Capital (Rs)
OLD BALANCE	4,050	+	5,600	+	53,080	+	12,000	=	12,000	+520	+ 62,210
EFFECT OF TRANSACTION 15:							- 100				- 100
NEW BALANCE	4,050	+	5,600	+	53,080	+	11,900	=	12,000	+520	+ 62,110

The above transactions when summarised will appear as shown below.

Summary of Transactions of X
for the month of April

	Assets				=	*Liabilities*	+ *Owner's equity*
Transaction + X's Capital	Cash +	Debtors +	Merchandise +		Furniture =	Creditors +	Rent Payable
	Rs	Rs.	Rs	Rs	Rs	Rs	Rs
1.	+ 50,000						+ 50,000
2.	-12,000			+ 12,000			
3	-24,000		+ 24,000				
4.			+ 40,000		+ 40,000		
5 (i)		+ 10,400					+ 10,400
(ii)			-7,280				- 7,280
6.	+ 4,800	- 4,800					
7. (i)	+ 5,200						+ 5,200
(ii)			- 3,640				- 3,640
8.	-12,000				-12,000		
9.	- 500						- 500
10.	+ 10,000						+ 10,000
11.	-16,000				-16,000		
12.	- 250						- 250
13.						+ 520	- 520
14.	1,200						- 1,200
15.				- 100			- 100
Balances:	4,050	+ 5,600	+ 53,080	+ 11,900 =	12,000	+ 520	+ 62,110

Illustration .

Prove that the Accounting Equation is satisfied in all the following transactions of Suresh.

1. Commenced business with cash Rs.60,000
2. Paid rent in advance Rs. 500
3. Purchased goods for cash Rs. 30,000 and on credit for Rs. 20,000
4. Sold goods for cash Rs. 30,000, costing Rs. 20,000
5. Paid salary Rs. 500 and salary outstanding Rs. 100
6. Bought motor-cycle for personal use for Rs. 15,000 for cash

SOLUTION

Transaction	*Assets*					= *Liabilities*				+ *Owners Equity*
	Cash	+ Goods	+Rent paid in advance			= Creditors+		Salary outstanding	+	Suresh's Capital
	(Rs)	(Rs)		(Rs)		(Rs)		(Rs)		(Rs.)
1. Suresh commences business with cash	+60,000								+	60,000
Beginning equation	60,000	+ 0	+	0	=	0	+	0	+	60,000
2. Paid rent in advance	-500		+	500						
New equation	59,500	+ 0	+	500	=	0	+	0	+	60,000
3 Purchased goods for cash and on credit	-30,000	+50,000			=	20,000				
New equation	29,500	+50,000	+	500	=	20,000	+	0	+	60,000
4. Sold goods for cash Rs.30,000 costing Rs. 20,000	+30,000	-20,000	+	0						+10,000
New equation	59,500	+30,000	+	500	=	20,000	+	0	+	70,000
5 Paid salary Rs 500 and salary outstanding Rs. 100	-500						+	100		-600
New equation	59,000	+30,000	+	500	=	20,000	+	100	+	69,400
6. Bought motor-cycle for personal use for cash	-15,000									-15,000
Ending Equation	**44,000**	**+30,000**	**+**	**500**	**=**	**20,000**	**+**	**100**	**+**	**54,400**

3.3 RULES OF DEBIT AND CREDIT

The recording of business transactions in the light of the Accounting Equation requires the understanding of the rules of debit and credit through accounts.

3.3.1 Definition of an Account

An account is a formal record of all transactions relating to changes in a particular item. Through it, transactions of similar nature are brought together at one place in a book called the ledger.

Format of Account

Account Name (Title)________________ Page No ________________

Dr Cr

Date		Particulars	Folio	Amount		Date		Particulars	Folio	Amount	
				Rs	P					Rs.	P

An account is divided into two sides as shown above The left side of an account is debit and the right side is credit. Thus, debit means to write an amount on the left side and credit means to enter the amount on the right side. In the abbreviated form, Dr. stands for debit and Cr. stands for credit.

3.3.2 Rules

The rules of debit and credit depend on the nature of an account. For this purpose, all the accounts are classified into the following five categories:

(i) Assets
(ii) Liabilities
(iii) Owner's equity
(iv) Revenues
(v) Expenses

The above classification is derived from the Accounting Equation in the following manner.

	Assets	=	Liabilities + Owner's equity
Or,	Assets	=	Liabilities + Owner's equity +Income
Or,	Assets+ Expenses	=	Liabilities + Owner's equity +Revenues
Or,	Assets	=	Liabilities + Owner's equity + Revenues — Expenses

Accordingly, RULES OF DEBIT AND CREDIT in respect of the various categories of accounts can be shown as below:

(1)
Assets

Debit	*Credit*
Increase(+)	Decrease(-)

(2)
Liabilities

Debit	*Credit*
Decrease (-)	Increase (+)

(3)
Owner's equity

Debit	*Credit*
Decrease (-)	Increase (+)

(4)
Revenue

Debit	*Credit*
Decrease (-)	Increase (+)

(5)
Expenses

Debit	Credit
Increase (+)	Decrease (-)

Both debit and credit may represent either increase or decrease depending on the nature of an account. In the case of assets and expenses, debit means increase and credit means decrease in assets and expenses. In the case of liabilities, owner's equity and revenues, debit represents decrease and credit represents increase. It may however, be noted that transactions relating to revenues and expenses ultimately result in either increase or decrease in owner's equity.

The rules of debit and credit relating to all the above types of accounts are summarised below

Nature/Type of account	*Debit*	*Credit*
Assets	Increase	Decrease
Liabilities	Decrease	Increase
Owner's equity	Decrease	Increase
Revenues	Decrease	Increase
Expenses	Increase	Decrease

Thus, all the transactions may be divided into the following five categories:

(i) Transactions relating to assets.
(ii) Transactions relating to liabilities.
(iii) Transactions relating to owner's equity
(iv) Transactions relating to revenues.
(v) Transactions relating to expenses.

3.4 DOUBLE ENTRY BOOK-KEEPING

The double entry book-keeping refers to a system

of accounting in which every transaction affects at least two accounts. This is the basis of the accounting equation also. It may, however, be noted that the double entry does not mean that a transaction must affect both sides of the Accounting Equation. (See transactions 2,3,6 and 13 in the summary of transactions on page 34.) But it does affect at least two items in an Accounting Equation. Transaction 2 and 3 only affected the left side of the equation by decreasing an asset (cash) and increasing assets (merchandise and furniture). After the recording of these transactions, the total of both sides of the equation remained unchanged, i.e Rs. 50,000.

In double entry book-keeping, the amount of every transaction is written twice, once as debit and again as credit, leading to the conclusion that in mathematical terms the sum of all the accounts will be zero, and in terms of the Accounting Equation, the sum total of all assets must be equal to the sum total of all the liabilities and the owner's equity. This equality holds true up to the last stage of the accounting process, ending with the preparation of the Balance Sheet.

3.5. BOOKS OF ORIGINAL ENTRY

These are the books of account in which a transaction is recorded for the first time from a source document Later, transactions from these books are transferred (posted) to the ledger. The following are the main books of original entry:

(a) Journal
(b) Cash book—single column, double column (cash and bank) and petty cash book
(c) Other day books :
  (i) Purchases book
  (ii) Sales book
  (iii) Purchases returns book
  (iv) Sales returns book

The meaning, format and entries in each of these books are illustrated below:

3.5.1 Journal

This is the basic book of original entry. In this book, transactions are recorded in a chronological order, as and when they take place. Afterwards, transactions from this book are posted to the ledger. Though transactions can be entered directly in the individual accounts in the ledger (as is generally done in the case of banks), it is more convenient and proper, particularly in a manual system, to record them in the journal. Thus, the journal provides a chronological record of all the transactions with details of the accounts debited and credited, and the amount of each transaction. Since each transaction is ultimately entered in at least two accounts, no single account will contain the complete record of a transaction. This is available only in the journal.

Format of Journal

Date		Particulars	L.F.	Debit Rs.	p.	Credit Rs	p.

Entries in the Journal

The recording of a transaction in the journal is called journalising. For each transaction, a separate entry is recorded. Before recording, the transaction is analysed to determine which account is to be debited and which account is to be credited. In the date column, the date of the transaction is entered; the year and month is written only once, till they change. The account to be debited is written first, close to the line in the particulars column. Against this, the amount is written in the debit column. In the second line, the account to be credited is written a few spaces away from the margin in the particulars column to make it distinct from the debit account. After each entry, a brief explanation of the transaction, called *narration*, is given in the particulars column. The Ledger Folio (L.F.) column is com-

posted to the ledger by of the ledger. Till such is blank.

The journal entries in respect of transactions used in the computation of the Accounting Equation earlier are shown below by way of illustration:

JOURNAL

s	L F	Debit Rs	Debit P	Credit Rs	Credit P
		50,000	-		
ital				50,000	-
d capital in the firm)					
		12,000	-		
				12,000	-
purchased for cash)					
ise		24,000	-		
				24,000	-
dise purchased for cash)					
ise		40,000	-		
				40,000	-
dise purchased on credit)					
i		10,400	-		
				10,400	-
dise sold on credit)					
ods sold		7,280	-		
andise				7,280	-
he merchandise sold transferred					
of goods sold account)					
		4,800	-		
m Lal				4,800	-
eived from					
l)					
		5,200	-		
s				5,200	-
dise sold					
oods sold		3,640	-		
chandise				3,640	-
nerchandise					
ferred to cost					
sold account)					
		12,000			
i			-	12,000	-
d to Shripat)					

Date 1988		Particulars	L F	Debit Rs	P	Credit Rs.	P
April	24	X's Drawings Cash X withdraw cash for his personel expenses		500	-	500	-
	25	Cash X's capital (X brought further capital)		10,000	-	10,000	-
	25	Shripat Cash (Cash paid to Shripat)		16,000	-	16,000	-
	26	Miscellaneous expenses Cash (miscellaneous expenses paid in cash)		250	-	250	-
	30	Rent Rent payable (Rent became due)		520	-	520	-
	30	Salaries Cash (Salaries paid)		1,200	-	1,200	-
	30	Depreciation Furniture (Depreciation charged on furniture)		100	-	100	-

Sub-Division of the Journal (Day Books)

All the business transactions are first recorded in the journal as explained above. From the journal, the transactions are posted to the ledger accounts and then the financial statements are prepared. (We shall discuss ledger and financial statements later). A small business may be able to record all its transactions in one book only, i.e. the journal. But as the business expands and the number of transactions become very large, it may become very cumbersome to journalise each transaction. Many of the transactions are repetitive in nature. They can be easily recorded in special journals, each meant for recording all the transactions of a similar nature. For example, all cash transactions may be recorded in one book, all credit sales transactions in another book and all credit purchases transactions in yet another book, and so on. These special journals are also called day books and can be ruled differently on the basis of the nature of transactions to be recorded. Transactions that cannot be recorded in any special journal are recorded in a journal called the general journal.

Special journals prove economical and make division of labour possible in accounting work. For example, in sales and purchases journals, each transaction may be recorded on a single line and two or more persons may be able to record transactions in both the books simultaneously. Posting to the ledger is also made easy since only periodical totals are posted to sales and purchases accounts.

The special journals are discussed below:

3.5.2 Cash Book

This book is used to record all transactions relating to cash receipts and cash payments. This is a very popular book and is maintained in all organisations— big or small, profit organisations or non-profit organisations. This serves the purpose of both journal as well as ledger account. Since transactions are recorded for the first time in the cash book, it is also a book of original entry. When a cash book is maintained, transactions of cash are not recorded in the journal.

Cash books can be of different types, viz., single column or simple cash book, double column cash book, triple column cash book(cash, bank and discount) multicolumn cash book and petty cash book. In big organisations, particularly banks, etc. there are separate cash books for cash receipts and cash payments. Here we shall confine our discussion to the single column cash book, double column cash book (cash and bank) and petty cash book

Single column cash book

A cash book which contains only one column of amount is called a single column or simple cash book. Its format is similar to an account and is shown below :

FORMAT OF SINGLE COLUMN CASH BOOK

Page ______

Dr. Receipts Payments Cr

Date	*Particulars*	*L.F*	*Amount*		*Date*	*Particulars*	*L.F*	*Amount*	
			Rs	*P*				*Rs*	*P*

Recording of entries in the single column cash book and its balancing are illustrated below:

CASH BOOK (SINGLE COLUMN)

Page ____

Dr.		Receipts						Payments			Cr
Date		*Particulars*	*L.F.*	*Amount* Rs.	P.	*Date*		*Particulars*	*L.F.*	*Amount* Rs	P
1988 April	1	X's Capital -R.1		50,000	-	1988 April	1	Furniture-V 1		12,000	-
							2	Merchandise -V.2		24,000	-
	10	Shyam Lal-R 2		4,800	-						
	12	Sales-R 3		5,200	-						
	25	X's Capital-R 4		10,000	-		3	Shripat-V.3		12,000	-
							24	X's Drawings-V.4		500	-
							25	Shripat-V 5		16,000	-
							26	Misc Expenses-V.5		250	-
							30	Salaries-V 6		1,200	-
							30	Balances c/d		4,050	-
				70,000	-					70,000	-
May 1		Balance b/d		4,050	—						

Note : R. stands for receipt number
V stands for voucher number

Double Column Cash Book (Cash and Bank)

In this type of cash book, there are two columns of amount on each side of the cash book. In fact, nowadays bank transactions are very large in number. In many organisations, as far as possible, all receipts and payments are affected through banks.

A businessman generally opens a current account with a bank. In this account, a customer can deposit and withdraw money without any restriction. Banks do not allow any interest on the balance in current account but charge a small amount, called bank charges, for the services rendered.

For depositing money/cheques in the bank accounts, a form has to be filled, which is available from the bank. It is called a **pay-in-slip.** It contains a counterfoil also which is returned to the customer (depositor) with the signature of the cashier, as a receipt.

The bank issues blank cheque forms, free of charge, to the account holder for withdrawing money. The depositor writes the name of the party to whom payment is to be made after the words "Pay to" printed on the cheque. Cheque forms have the printed word bearer, which means payment is to be made to the person whose name has been written after the words "Pay to"or the bearer of the cheques. When the word'bearer'is struck off by drawing a line, the cheque becomes an order cheque. It means payment is to be made only to the person whose name is written on the cheque or to his order after proper identification.

Cheques are generally crossed in practice. The payment of a crossed cheque cannot be made direct to the party on the counter. It is to be paid

TYPES OF CROSSINGS

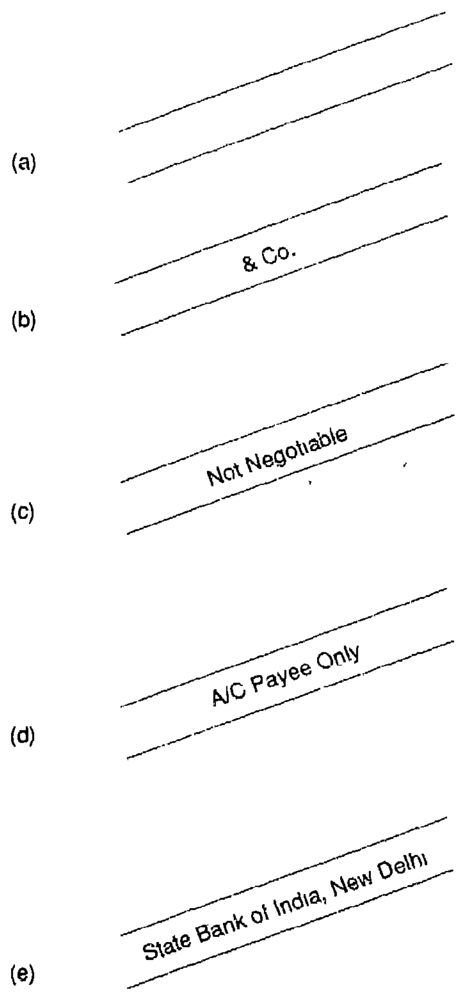

Figure 3 1

only through a bank. When two parallel lines are drawn across the cheque, it is said to be crossed. The following are the various types of crossing providing different degrees of safety to the payment.

In case of an 'A/c Payee only' crossing, the amount of the cheque can be deposited only in the account of the person whose name appears on the cheque When the name of the bank is written between two parallel lines, it becomes a special crossing and the payment can be made only to the bank whose name has been written between the two lines.

Though this is rarely done, a cheque can be transferred by the payee (the person in whose favour the cheque has been drawn) to another person, if it is not crossed "A/c Payee only". A bearer cheque can be passed on by mere delivery. An order cheque can be transferred by endorsement and delivery. Endorsement means the writing of instructions to pay the cheque to a particular person and then signing it. This is done on the back of the cheque.

When the number of bank transactions is large, it is convenient to have a separate amount column for bank transactions in the cash book itself instead of recording them in the journal. This helps in getting information about the position of the bank account from time to time. Just like cash transactions, all payments into the bank are recorded on the left side and all withdrawals/payments through the bank are recorded on the right side. When cash is deposited in the bank or cash is withdrawn from the bank, for meeting cash expenses in the organisation, both the entries are recorded in the cash book. This is so because both aspects of the transaction appear in the cash book itself. When cash is paid into the bank, the amount deposited is written on the left side in the bank column and at the same time the same amount is entered on the right side in the cash column. The reverse entries are passed when cash is

withdrawn from the bank for use in the office. Against such entries the word 'C', which stands for contra, is written on both the sides to signify that these entries are not to be posted to the ledger.

The bank column is balanced in the same way as the cash column. However, in the bank column, there can be credit balance also because of overdraft taken from the bank. Overdraft is a situation when cash withdrawn from the bank exceeds the amount of cash deposited.

Entries in respect of cheques received should be made in the bank column of the cash book. Some accountants enter the cheques received first in the cash column and when they are actually deposited with the bank, they pass the same entries as in the case of cash deposited in the bank. But this is not necessary as the cheques will be sent to the bank at the earliest.

If a cheque received from a customer is dishonoured, the bank will return the dishonoured cheque and debit the firm's account. On receipt of such cheque/intimation from the bank, the firm should make an entry on the credit side of the cash book by entering the amount of the dishonoured cheque in the bank column and the name of the customer in the particulars column. This entry will restore the position prevailing before the receipt of the cheque from the customer and its deposit in the bank. Dishonour of a cheque means return of the cheque unpaid, generally due to insufficient funds in the customer's account with the bank.

If the bank debits the firm on account of interest, commission or other charges for bank services, the entry will be made on the credit side in bank column. If the bank credits the firm's account, the entry will be made on the debit side of the cash book in the appropriate columns.

The format and entries in the two-column cash book are illustrated below:

Illustration :

Enter the following transactions in the double column cash book of Mr. X and balance it.

		Rs.
1988 May		
1	Opening balance: Cash in hand	1,350
	Cash in bank	4,000
2	Paid to petty cashier	500
2	Sold goods for cash	1,200
2	Paid to Shripat by cheque	2,000
3	Received cheque from Shyamlal	1,500
4	Received cheque from D.K. Bahal	4,000
5	Purchased goods for cash	1,500
10	Sold goods for cash	800
12	Withdrew cash from bank	1,000
15	Purchased stationary for cash	400
20	Sold goods for cash	8,000
20	Deposited cash in bank	7,000
25	Withdrew from bank for personal use	500
31	Paid salaries in cash	1,200

SOLUTION

Cash Book (Two Columns-Cash and Bank)

Dr. Receipts Payments Cr

Date 1988		Particulars	L.F	Cash Rs.	P	Bank Rs.	P.	Date 1988		Particulars	L.F	Cash Rs	P.	Bank Rs.	P
May	1	Balance b/d		1350	00	4 000	00	May	2	Petty cash		500	00		
	2	Sales		1,200	00				2	Shripat				2,000	00
									5	Merchandise		1,500	00		
	3	Shyam Lal				1,500	00		9	Rent payable				520	00
	4	D.K.Bahal				4,000	00		12	Cash	C			1,000	00
	10	Sales		800	00				15	Stationery		400	00		
	12	Bank	C	1,000	00				20	Bank	C	7,000	00		
	20	Sales		8,000	00										
	20	Cash	C			7,000	00		25	X's drawings				500	00
									31	Salaries		1,200	00		
									31	Balance c/d		1,750	00	12,480	00
				12,350	00	16,500	00					12,350	00	16,500	00
June	1	Balance b/d		1,750	00	12,480	00								

Note : Receipt/Voucher numbers have been omitted.

Petty Cash Book

In every organisation, a large number of small payments such as for conveyance—bus, taxi, cartage, postage, telegrams and other miscellaneous expenses are made. These are generally repetitive in nature. If all these payments are handled by the cashier and are recorded in the main cash book, the procedure is found to be very cumbersome. The cashier may be overburdened and the cash book may become very bulky. To avoid this, large organisations normally appoint one more cashier. He makes all small payments and records them in his cash book, which is called the petty cash book and he is called the petty cashier.

The petty cashier works on the **imprest system**. In the imprest system of cash, a definite sum say Rs 500, is given to the petty cashier at the beginning of a certain period. This amount is called imprest money. The petty cashier goes on making all small payments out of this imprest amount and when he has spent the substantial portion of his imprest amount say Rs. 477, he gets reimbursement of the amount spent from the main cashier. Thus, he again has the full imprest amount. The reimbursement may be made on a weekly, fortnightly or monthly basis, depending on the frequency of small payments.

In certain cases, the petty cash system is operated through the main cash book itself. In such instances, the petty cash book is not maintained independently.

The petty cash book generally has a number of columns for the amount on the payment side (cr.) besides the first total amount column. Each of the other amount columns is allotted for items of specific payments which are most common. One last amount column is designated as 'Miscellaneous' followed by a 'Remarks' column. In the miscellaneous column, such payments are recorded for which a separate column does not exist, and in the remarks column, the nature of

payment is recorded. At the end of the period, all amount columns are totalled, and the total amount column will show the total amount spent and to be reimbursed On the receipt (debit) side, there is only one amount column. Columns for the date, voucher number and particulars are common for both receipts and payments.

The format and entries in the petty cash book are illustrated below:

Illustration

A petty cashier is paid Rs. 500 as imprest money on Monday, May 2, 1988. During the month his expenses were as under:

			Rs.
May	2	Taxi fare for manager	45.00
		Wages to casual workers	70.00
	3	Stationery	30.00
		Bus fare	2.00
	14	Postage stamps purchased	15.00
		Telegrams	42.00
	15	Repairs to furniture	36.00
		Taxi fare for manager	33.00
		Telegrams to suppliers	13.50
	26	Electricity bill for February	118.00
		Stationery	14.00
	27	Refreshment for visitors	16.00
		Cartage for goods purchased	34.00

Record the above transactions in the petty cash book. (See solution on the next page.)

Balancing of Cash Book

On the left side, all cash transactions relating to cash receipts (debits) and on the right side all transactions relating to cash payments (credits) are entered date-wise. When a cash book is maintained, a separate cash account in the ledger is not opened. The cash book is balanced in the same way as an account in the ledger. But it may be noted that in the case of the cash book, there will always be debit balance because cash payments can never exceed cash receipts and cash in hand in the beginning of the period

The source document for cash receipts is generally the duplicate copy of the receipt issued by the cashier. For payment, any document, invoice, bill, receipt, etc. on the basis of which payment has been made will serve as a source document for recording transactions in the cash book. When payment has been made, all these documents, popularly known as vouchers, are given a serial number and filed in a separate file for future reference and verification.

3.5.3 Other Day Books

When there are a large number of transactions of the similar type, the firm can maintain a special journal for recording transactions of similar nature in one book only. In that case, special types of transactions such as purchases, sales, purchases returns, sales returns are recorded in special journals and the remaining transactions are recorded in the journal called the general journal. Special journals are also called day books.

Special journals are now explained below. (Cash book has already been explained.)

(i) Purchases Journal (Book)

All credit purchases of merchandise are recorded in the purchases journal, cash purchases are recorded in the cash book. Other purchases such as purchase of office equipment, furniture, building, are recorded in the general journal if purchased on credit or in the cash book if purchased for cash. The source documents for recording entries in the book are invoices or bills received by the firm from the suppliers of the goods. Entries are made with the net amount of the invoice. Trade discount and other details of the invoice need not be recorded in this book. The format of the purchases journal is the same as that

SOLUTION:

PETTY CASH BOOK

Dr. Cr

Amount received		Date		Voucher No.	Particulars	Total Amount		Conveyance		Stationery		Postage and Telegrams		Cartage		Miscellaneous		Remarks
Rs.	P					Rs	P.	Rs	P.	Rs	P	Rs	P	Rs	P	Rs.	P	
500	00	May	2		Cash received													
			2	1	Taxi fare for manager	45	00	45	00									
				2	Wages to casual workers	70	00									70	00	Wages
			3	3	Stationery	38	00			38	00							
				4	Bus fare	2	00	2	00									
			14	5	Postage stamps	15	00					15	00					
				6	Telegrams	42	50					42	50					
			15	7	Repairs to furniture	36	00									36	00	Repairs
				8	Taxi fare for manager	33	00	33	00									
			26	9	Telegrams	13	50					13	50					
				10	Electricity bill for February, 1988	118	00									118	00	Electricity
				11	Stationery	14	00			14	00							
			27	12	Refreshments for visitors	16	00									16	00	Entertainment
				13	Cartage for goods	34	00							34	00			
						477	00	80	00	52	00	71	00	34	00	240	00	
			31		Balance c/d	23	00											
500	00	June	1			500	00											
23	00	June	1		Balance b/d													
477	00				Cash received													

of the general journal except that one more column for the invoice number is added after the date column, while one amount column is deleted. The monthly total of the purchases book is posted to the debit of Purchases Account in the ledger. Individual suppliers' accounts may be posted daily.

The format and preparation of the purchases journal is illustrated below: (Folio numbers have been omitted)

Purchases Journal

Date 1988		Invoice No.	Name of Supplier (Account to be credited)	L F	Amount Rs	P.
April	1	1011	Gupta Bros , New Delhi		1,509	00
	5	2004	Elite Industries New Delhi		1,344	00
	12	5415	Mohammed Usman		533	00
	24	5773	John Payace		767	00
					4,153	00

customer and to be paid to the government within the stipulated time. Periodically, at the close of each month the amount column is totalled and posted to the credit of Sales Account in the ledger. Posting to the debit side of individual customers' accounts may be made daily.

The format and preparation of the sales journal are illustrated below:

Sales Journal

Date 1988		Invoice No.	Name of the Customer (Account to be debited)	L F	Amount Rs.	P.
April	2	201	Ram Kumar, New Delhi		505	00
	5	202	D.K Gupta, Ludhiana		710	00
	10	203	A K Sharma, Shahadra		910	00
	12	204	Rahim Ali, New Delhi		424	00
	29	205	I Johnes, New Delhi		1228	00
					3777	00

(ii) Sales Journal book

All credit sales of merchandise are recorded in the sales journal. Cash sales are recorded in the cash book. The format of the sales journal is similar to that of the purchases journal explained earlier. The source documents for recording entries in the sales journal are sales invoices or bills issued by the firm to the customers. The date of sale, invoice number, name of the customer and amount of the invoice are recorded in the sales journal. Other details about the sales transaction including terms of payment are available in the invoice. In fact, two or more than two copies of a sales invoice are prepared for each sale. The book keeper makes entries in the sales journal from one copy of the sales invoice. In the sales journal, one additional column may be added to record sales tax recovered from the

(iii) Purchases Returns Journal(Book)

In this book, purchases returns of merchandise purchased on credit are recorded. Sometimes, goods purchased are returned to the supplier for various reasons such as the goods are not of the required quality, or are defective, etc. For every return, a *debit note* (in duplicate) is prepared and the original one is sent to the supplier for making necessary entries in his book. The supplier may also prepare a note which is called the *credit note*. The source document for recording entries in the purchases returns journal is generally a debit note. A debit note will contain the name of the party (to whom the goods have been returned), details of the goods returned and the reason for returning the goods. Each debit note is serially numbered and dated. The format of the purchases returns journal is also similar to

that of the purchases journal.

The format and preparation of the purchases returns journal are illustrated below:

Purchases Returns Journal

Date 1988		Debit Note No.	Name of the supplier (Account to be debited)	L F	Amount Rs.	P.
April	3	25	Gupta Bros., New Delhi		72	00
	8	26	Elite Industries, New Delhi		180	00
					252	00

(iv) Sales Returns Journal (Book)

This journal is used to record sales returns from customers of the goods sold to them on credit. On receipt of goods from the customer, a credit note is prepared, like the debit note referred to earlier. The difference between the credit note and the debit note is that the former is prepared by the seller and the latter is prepared by the purchaser. Like the debit note, the credit note is also prepared in duplicate and contains details relating to the name of the customer, details of the merchandise received back and the amount. Each credit note is serially numbered and dated. The source document for recording entries in the sales returns book is generally the credit note. The format of the sales returns journal is similar to that of the purchases returns journal.

The format and preparation of the sales returns journal are illustrated below:

Sales Returns Journal

Date 1988		Credit Note No.	Name of the Customer (Account to be credited)	L.F.	Amount Rs.	P.
April	3	11	Ram Kumar, New Delhi		30	00
	30	12	J. Johns, New Delhi		58	00
					88	00

3.6 LEDGER

The ledger is the main book of accounting system.

3.6.1 Meaning, utility, format, distinction between the book of original entry and ledger

Meaning

A ledger is a collection of all the accounts debited or credited in the general journal and various special journals. A ledger may be in the form of a bound register, or cards, or separate sheets may be maintained in a loose leaf binder. In the ledger, each account is opened preferably on a separate page or card.

Utility

A ledger is very useful and is of the utmost importance in any organisation. The relationship of the firm in respect of a particular account on a given date can be ascertained only from the ledger. For example, if the management wants to know on a particular date the amount due from a certain customer, or the amount the firm has to pay to a particular supplier, such information can be found only in the ledger. The various transactions pertaining to an account may be spread over in the journal in various pages, but in the ledger all these will be recorded on one page. For easy posting and location, accounts are opened in the ledger in some definite order. For example, they may be opened in the same order as they appear in the Profit and Loss Account and Balance Sheet. In the beginning, an index is also provided. For easy identification, in big organisations, each account is also alloted a code number.

Format

The ledger account is conventionally in 'T' shape and, thus, sometimes called 'T' account. The left side of the T account is called the debit side and the right side is called the credit side. In other words, all debits will be recorded on the left

side and all credits will be recorded on the right side. In practice, each side of the account has fo columns to record necessary details of each transaction as shown below:

Account

Dr. C

Date (1)	*Particulars* (2)	*Folio* (3)	*Amount* (4)		*Date* (1)	*Particulars* (2)	*Folio* (3)	*Amount* (4)	
			Rs.	P				Rs.	P

According to this format, the ledger account is written in the following manner:

(1) The date on which a transaction is recorded.

(2) Particulars relating to a transaction.

(3) In this column, a reference is made to the page number of the book of original entry.

(4) The amount involved in the transaction is entered on .

An account is debited or credited according to the rules of debit and credit already explained in respect of each category of account.

Difference Between Books of Original Entry and Ledger

Books of original entry and the ledger are very important books of account in the double entry system of accounting. However, they differ from each other in certain respects. The important, points of difference between the two are mentioned below:

(i) Books of original entry, as the name indicates, refers to those books in which original entries of transactions are recorded. Since entries are entered for the first time in these books, they are also referred to as books of first entry, or primary entry.

Ledger is the book in which entries are recorded by transferring from the books of original entry. In the accounting process, recording of entries in the ledger is the second stage, therefore, the ledger is also called a book of secondary entry.

(ii) In the books of original entry, transactions are recorded in a chronological order, as and when they take place. If one wants to know the status of an account at a particular time, it may not be possible from the books of original entry.

The ledger contains, at one place, all the transactions relating to a particular account, in order of their occurrence. Thus, the ledger is analytical in nature and one can easily know the position of an account at any point of time, if all the postings have been made from the books of original entry to the ledger up to date.

(iii) The format of the original books of entry is different from that of the ledger. In the journal, there is one column for particulars and two columns for amount, one for debit

and another for credit. Other special journals have only one column of amount signifying either all debits or all credits in relation to the parties.

In the case of the ledger, there are two equally divided sides having identical columns. The left side is known as debit and the right side is known as credit.

(iv) In the books of original entry, balancing is not done. In the ledger, all the accounts are balanced.

(v) From the books of original entry, entries are transferred to the ledger.

From the ledger, first, the trial balance is drawn and then from the trial balance financial statements are prepared.

(vi) The process of recording entries in the books of original entry is called journalising.

The process of recording entries in the ledger is called 'posting'.

3.6.2 Classification of Ledger Accounts

We have seen earlier that all ledger accounts are put into five categories, viz., assets, liabilities, capital, revenue and expense. All these accounts may further be put into two groups, viz., permanent accounts and temporary accounts. All permanent accounts are balanced and carried forward to the next accounting period. The temporary accounts are closed at the end of the accounting period by transfer to the Trading and Profit and Loss Account. All permanent accounts will appear in the Balance Sheet. Thus, all assets, liabilities and capital accounts are permanent accounts and all revenues and expenses accounts are temporary accounts. This classification is also relevant for preparing financial statements.

3.6.3 Posting from Journal, Cash Book and Day Books

Posting is the process of transferring entries from books of original entry to the ledger. In other words, posting means grouping of all the transactions in respect of one particular account at one place for meaningful conclusion and to further the accounting process. Posting may be done daily or periodically, viz., weekly, fortnightly or monthly, according to the convenience and requirements of the business. The complete process of posting from the books of original entry to the ledger has been discussed below:

Posting from Journal

For posting entries from the journal to the ledger, the following steps are to be taken:

(1) Locate in the ledger, the account to be debited or credited as entered in the journal

(2) If an account is to be debited, enter the date of the transaction in the date column on the debit side.

(3) In the 'particulars column' write the name of the account through which it has been debited in the journal. For example, when X pays Rs. 50,000 in cash as his capital, cash is debited and X's capital is credited in the journal. Now in the ledger, in cash account on the debit side in the particulars Column 'X's capital' will be entered signifying that cash was received by way of X's capital. In X's capital account, in the ledger on the credit side in the particulars column, the word, cash will be recorded, signifying that X gave to the firm cash as capital. The same procedure is followed in respect of all the entries recorded in the journal.

(4) Enter the page number of the journal in the folio column and in the journal write the page number of the ledger on which a particular account appears.

(5) Enter the relevant amount in the relevant amount column.

It may be noted that the same procedure is followed for entering credit entries in the ledger. An account is opened only once in the ledger and all entries relating to a particular account are posted on the debit or credit side, as the case may be.

Illustration

Transactions journalised earlier on pages 39 and 40 are now posted in the ledger in various accounts as given below: (Folio numbers have been omitted.)

LEDGER

Cash

Dr. Cr.

Date 1988		*Particulars*	*Folio*	*Amount* Rs.	P	*Date* 1988		*Particulars*	*Folio*	*Amount* Rs.	P
April	1	X's capital		50,000	-	April	1	Furniture		12,000	-
	10	Shyam Lal		4,800	-		2	Merchandise		24,000	-
	12	Sales		5,200	-		20	Shripat		12,000	-
	25	X's capital		10,000	-		24	X's Drawings		500	-
							25	Shripat		16,000	-
							26	Misc Expenses		250	-
							30	Salaries		1,200	-

X's Capital

Dr. Cr.

Date 1988		*Particulars*	*Folio*	*Amount* Rs	P	*Date* 1988		*Particulars*	*Folio*	*Amount* Rs.	P.
						April	1	Cash		50,000	-
							25	Cash		10,000	-

X's Drawings

Dr. Cr.

Date 1988		*Particulars*	*Folio*	*Amount* Rs.	P	*Date* 1988		*Particulars*	*Folio*	*Amount* Rs	P.
April	24	Cash	14	500							

Merchandise

Dr. Cr.

Date 1988		Particulars	Folio	Amount Rs	P	Date 1988		Particulars	Folio	Amount Rs	P
April	2	Cash		24,000	-	April	5	Cost of goods sold		7,280	-
	5	Shripat		40,000	-		12	Cost of goods sold		3,640	-

Sales

Dr. Cr

Date 1988		Particulars	Folio	Amount Rs	P	Date 1988		Particulars	Folio	Amount Rs.	P.
						April	5	Shyam Lal	1	10,400	00
							12	Cash	2	5,200	00

Cost of Goods Sold

Dr Cr.

Date 1988		Particulars	Folio	Amount Rs	P.	Date 1988		Particulars	Folio	Amount Rs	P.
April	5	Merchandise	5	7,280	-	1988					
	12	Merchandise		3,640	-						

Shripat

Dr. Cr.

Date 1988		Particulars	Folio	Amount Rs	P	Date 1988		Particulars	Folio	Amount Rs.	P.
April	20	Cash		12,000	00	April	5	Merchandise		40,000	00
	25	Cash		16,000	00						

Shyam Lal

Dr. Cr.

Date 1988		Particulars	Folio	Amount Rs.	P.	Date 1988		Particulars	Folio	Amount Rs	P.
April	5	Sales		10,400	00	April	10	Cash		4,800	00

Furniture

Dr. Cr.

Date 1988		Particulars	Folio	Amount Rs	P.	Date 1988		Particulars	Folio	Amount Rs	P
April	1	Cash		12,000	00	April	20	Depreciation		100	00

Miscellaneous Expenses

Dr. Cr.

Date 1988		Particulars	Folio	Amount Rs.	P.	Date 1988		Particulars	Folio	Amount Rs	P.
April	26	Cash		250	00						

Salaries

Dr Cr

Date 1988		Particulars	Folio	Amount Rs.	P	Date 1988		Particulars	Folio	Amount Rs.	P
April	30	Cash	1	1,200	00						

Rent

Dr. Cr

Date 1988		Particulars	Folio	Amount Rs.	P.	Date 1988		Particulars	Folio	Amount Rs.	P
April	30	Rent payable		520	00						

Dr. **Depreciation** Cr.

Date 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*	*Date* 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*
April	30	Furniture		100	00						

Dr. **Rent Payable** Cr

Date 1988		*Particulars*	*Folio*	*Amount* *Rs.*	*P*	*Date* 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*
						April	30	Rent		520	00

Posting from Cash Book

The left side of the cash book shows receipts of cash or amount deposited in the bank from various sources. All those accounts through which cash/bank has been debited are opened in the ledger.

All the accounts appearing on the debit side of the cash book are credited because cash/cheque has been received in respect of them. Thus, if on the debit side of the cash book, an entry 'Shyam Lal Rs. 4,800' appears, it means that cash has been received from Shyam Lal. Therefore, in the ledger, Shyam Lal's account will be credited by writing, 'Cash Rs. 4,800' in the relevant columns.

The right side of the cash book shows all the payments made in cash or through the bank. All the account names apearing on the credit side of the cash book are debited as cash/cheque has been paid in respect of them.

It may be noted that, when the bank column is maintained in the cash book, the bank account is not opened in the ledger. The bank column serves the purpose of a bank account. All entries marked 'C' (being contra entries as explained earlier) are ignored while posting from the cash book to the ledger. These entries represent debit or credit of cash accounts against the bank account or vice versa.

Posting from the petty cash book is made at the end of the month. Totals of various amount columns and amounts against specific expenses entered in the "miscellaneous column" of the petty cash book are posted to the debit side of the concerned ledger accounts on the last day of the month as sundries, indicating that all petty amounts for the month have been put together. The ledger folio number is written under every total expense amount to indicate that the entry has been posted in the ledger. In the folio column of the ledger account, the page number of the petty cash book is written for cross/future reference purposes.

Illustration.

Posting from the double column cash book apearing on page 45 and petty cash book appearing on page 47 are shown below:
(Folio numbers have been omitted.)

Dr **Sales** Cr

Date		*Particulars*	*Folio*	*Amount Rs*	*Date*		*Particulars*	*Folio*	*Amount Rs*
					May	2	Cash		1,200
					May	10	Cash		800
					May	20	Cash		8,000

Dr **Shripat** Cr

1988									
May	2	Bank		2,000					

Dr **Shyam Lal** Cr

					1988				
					May	3	Bank		1,500

Dr. **Merchandise** Cr

1988									
May	5	Cash		1,500					

Dr **D K Bahal** Cr.

					1988				
					May	4	Bank		4,000

Dr **Rent Payable** Cr.

1988									
May	9	Bank		520					

Dr **Stationery** Cr

1988									
May	15	Cash		400					
May	31	Sundries		52					

Dr **Conveyance** Cr

1988									
May	31	Sundries		80					

Dr. **X's Drawings** Cr

1988									
May	25	Bank		500					

Dr. **Postage and Telegrams** Cr.

1988									
May	31	Sundries		71					

Dr. **Cartage** Cr.

1988									
May	31	Sundries		34					

Dr. Salaries Cr.

1988 May	31	Cash		1,200				

Dr. Electricity Cr

1988 May	31	Sundries		118				

Dr Wages Cr

1988 May	31	Sundries		70				

Dr. Entertainment Cr

1988 May	31	Sundries		16				

Dr. Repairs Cr

1988 May	31	Sundries		36				

Posting from Day Books

In all the day books, transactions relate to the parties concerned. All the individual transactions recorded in day books and totalled for the month are posted to the ledger.

The posting procedure is briefly narrated and illustrated below :

Posting from the Purchases Journal

Posting to suppliers accounts is done daily to their respective accounts with the relevant amounts on the credit side.

The total of the purchases journal is periodically posted to the debit of the purchases account as sundries, normally on a monthly basis However, if the number of transactions is very large, this total may be done and posted at some other convenient time interval such as daily, weekly or fortnightly.

The posting from purchases journal to the ledger is illustrated below (Folio numbers are omitted):

Purchases Journal

Date		Invoice No.	Name of Supplier	L F	Amount Rs	P
1988 May	5	110	B. Bansilal, Bombay		1,040	-
	7	200	A Arnold, Calcutta		1,240	-
	10	305	C. Chatterji, Calcutta		942	-
	15	140	D Dass, Madras		1,165	-
	22	501	Desai & Co., Surat		2,190	-
	31	160	Damodar & Co , Bombay		761	-
			Total		7,338	

The above entries in the Purchases Book, when posted into the ledger will appear as under ·

Dr B Bansilal, Bombay Cr

Date		Particulars	Folio	Amount Rs.	P	Date 1988		Particulars	Folio	Amount Rs	P
						May	5	Merchandise		1,040	

Dr A. Arnold, Calcutta Cr

Date		Particulars	Folio	Amount Rs	P.	Date 1988		Particulars	Folio	Amount Rs	P.
						May	7	Merchandise		1,240	

Dr C. Chatterji, Calcutta Cr

Date		Particulars	Folio	Amount Rs.	P	Date 1988		Particulars	Folio	Amount Rs	P
						May	10	Merchandise		942	

Dr D. Dass, Madras Cr

Date		Particulars	Folio	Amount Rs	P	Date 1988		Particulars	Folio	Amount Rs	P.
						May	15	Merchandise		1,165	

Dr Desai & Co., Surat Cr

Date		Particulars	Folio	Amount Rs	P	Date 1988		Particulars	Folio	Amount Rs	P.
						May	22	Merchandise		2,190	

Dr Damodar & Co , Bombay Cr

Date		Particulars	Folio	Amount Rs.	P	Date 1988		Particulars	Folio	Amount Rs	P
						May	31	Merchandise		761	

Dr Merchandise/Purchases Cr.

Date 1988		Particulars	Folio	Amount Rs	P	Date 1988		Particulars	Folio	Amount Rs	P.
May	31	Sundries		7,338							

Posting from the Sales Journal

The sales journal contains transactions relating to credit sale of goods to various customers. From the sales journal, entries are posted to the debit of customers' accounts kept in the ledger. Like the

purchases journal, individual customers' accounts are generally posted daily, with the amount involved. The sales journal is also totalled periodically (generally monthly), and this total is credited to sales account in the ledger.
The posting from sales journal to the ledger is illustrated below: (Folio numbers are omitted)

Sales Journal

Date 1988		Invoice No	Name of the Customer	L.F	Amount Rs	P
May	7	101	E Evans, Calcutta		2,530	
	10	102	C. Tripathi, Kanpur		2,545	
	15	103	F Francis, Madras		3,090	
	20	104	J Jones, Shimla		4,030	
	23	105	T Shah, Bombay		2,050	
			Total		14,245	

The above entries when posted to the ledger will appear as under

Dr E Evans, Calcutta Cr

Date 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*	*Date* 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*
Feb ,	7	Sales		2,530							

Dr C Tripathi, Kanpur Cr

Date 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*	*Date* 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*
Feb.,	10	Sales		2,545							

Dr F Francis, Madras Cr

Date 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P.*	*Date* 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*
Feb ,	15	Sales		3,090							

Dr. J Jones, Shimla Cr.

Date 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*	*Date* 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*
Feb ,	20	Sales		4,030							

Dr T Shah, Bombay Cr.

Date 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*	*Date* 1988		*Particulars*	*Folio*	*Amount* *Rs*	*P*
Feb.,	23	Sales		2,050							

Dr. Sales Cr.

Date		Particulars	Folio	Amount Rs	P.	Date 1988		Particulars	Folio	Amount Rs	P
						Feb	29	Sundries		14,245	-

Posting from the Purchases Returns (Returns Outward) Journal

The posting from the purchases returns journal requires that the suppliers' individual accounts are debited with the amount of returns and the purchases returns account is credited with the periodical total, as is done in the case of posting from the sales journal.

Posting from the Sales Returns (Returns Inward) Journal

The posting from the sales returns journal requires that the customer's account be credited with the amount of returns and the sales returns account be debited with the periodical total in the same way as is done in the case of posting from the purchases journal.

3.6.4 Balancing of Accounts

Accounts in the ledger are periodically balanced, generally at the end of the accounting period, with the object of ascertaining the precise position of the business firm with regard to them.

Balancing of an account means that the two sides are totalled and the difference between them is inserted on the side which is shorter in order to make their totals equal. The words 'balance c/d' are written against the amount of the difference between the two sides The amount of balance is brought down in the next accounting period indicating that it is a continuing account, till finally settled or closed.

In case the debit side exceeds the credit side, the difference is written on the credit side, if the credit side exceeds the debit side, the difference between the two appears on the debit side and is called debit and credit balance respectively.

The balancing of an account is illustrated below. (Shyam Lal Account)

In practice, during the currency of the financial year, accounts are totalled by pencil periodically, say monthly, and the trial balance is also drawn every month to facilitate the location of errors. At the close of the accounting year, after tallying the trial balance, these totals may be written in ink

3.7 BANK RECONCILIATION STATEMENT

It is generally experienced that the bank balance shown by the cash book does not tally with the balance reported by the bank. A mechanism is required to locate the difference between the two balances and to cross check the two balances.

Dr. Shyam Lal Cr

Date 1988		Particulars	Folio	Amount Rs.	P	Date 1988		Particulars	Folio	Amount Rs	P
April	5	Sales		10,400		April	10	Cash	2	4,800	-
								Balance c/d		5,600	-
				10,400						10,400	
May	1	Balance b/d		5,600							

Such a mechanism is the bank reconciliation statement

3.7.1 Meaning

It is a statement prepared to show the items of difference between the bank balance as shown by the bank pass book (statement) and the cash book/ bank column in the cash book. There are various factors due to which these two balances differ. These factors are:

(i) Cheques issued by the firm but not yet presented for payment

When a cheque is issued to the creditor in payment of his dues, it is immediately recorded in the cash book in the bank column, thus, reducing the bank balance. But the bank will debit the firm's account only when this cheque is actually presented to the bank for payment. Generally, there is a time lag between the issue of a cheque and its presentation to the bank. If accounts are closed in the intervening period, there will be difference between the bank balance shown by the cash book and the balance shown by the bank pass book.

In the case of crossed cheques, this probability is very high since such cheques can be presented for payment only through a bank. Thus, there will be difference between the two balances to the extent of the amount of such cheques.

(ii) Cheques paid into the bank but not yet collected

When a firm receives cheques from its customers, they are immediately deposited with the bank for collection for crediting the proceeds in the firm's account. When a firm deposits the cheques with the bank, it immediately debits the bank account. But the bank will credit the firm's account only after these cheques have been collected. The collection generally takes a few days. In the case of outstation cheques, this gap may be longer. In the intervening period there is bound to be a difference between the bank balance as shown by the cash book and the balance shown by the bank pass book.

(iii) Interest credited by the bank

In the case of savings bank account, etc the bank allows interest on the minimum balance of each month in the account of the customer. This interest is credited in the customers account generally at the end of six months. Such credit increases the bank balance of the party But the account holder may get his pass book duly completed after a gap of time. This will cause a difference between the two balances

(iv) Interest and expenses charged by the bank

The bank charges interest on overdrafts, if any, and some commission, etc., for the services rendered to the customer These are called bank charges. The bank debits the customer's account with these charges from time to time. But the customer will record these in the cash book either on receiving intimation from the bank in this regard or when he receives the bank pass book duly completed. In the intervening period, the two balances will differ

(v) Credits by the bank without the knowledge of the firm

There are instances when the bank directly receives dividend/interest on the investments made by the firm. Moreover, a customer may directly deposit the amount due in the firm's bank account. The bank credits the firm's account immediately on receipt of such payments, but the firm will make entries in the cash book only after receiving intimation in this regard.

(vi) Direct payments made by the bank on behalf of the customer

An account holder instructs the bank to make certain payments such as insurance premium, on

his behalf. The bank will debit the party's account on making the payment, but the firm will be able to record these transactions in the cash book only on receipt of intimation from the bank.

(vii) Dishonour of a bill discounted with the bank

Occasionally, the customer discounts a bill of exchange before its maturity with the bank. If, on the due date, such a bill is not honoured by the acceptor, the bank will debit the customer's account The customer will record entries in this regard only on receiving intimation from the bank. Dishonoured cheques also have the same effect.

(viii) Errors and omissions

An error or omission either on the part of the customer or the bank will cause a difference between the bank balance shown by the cash book and the balance shown by the bank pass book. A difference on this ground can be eliminated when the error/omission is detected.

3.7.2 Need and Importance

It is essential to tally the bank balance shown by the cash book with the balance shown by the bank pass book and, in case of any difference, to identify the reasons for the difference. This is possible only by preparing a bank reconciliation statement. The importance of this statement lies in the fact that it ensures that the bank balance shown by the cash book is reconciled with that of the bank pass book. In the absence of a bank reconciliation statement, the customer cannot be sure of the correctness of the bank balance depicted by the cash book. Hence, periodic preparation of the bank reconciliation statement is essential.

3.7.3 Preparation of the Bank Reconciliation Statement

As already stated, the bank reconciliation statement is prepared to reconcile the bank balance shown in the cash book with the balance shown by the bank pass book Before preparing the bank reconciliation statement, items appearing in the bank pass book are checked and ticked with the items appearing in the cash book. All such items which remain unticked in both the books—cash book and bank pass book—are listed according to the nature of their difference.

Thereafter, the bank reconciliation statement is prepared on the following lines.

(i) The date on which the statement is being prepared is written at the top, as part of the heading.

(ii) The first item in the statement is generally the balance as shown by the bank pass book. Alternatively, the starting point can be the balance as per cash book.

(iii) The cheques deposited but not yet collected are added to the balance as per bank pass book.

(iv) All the cheques issued but not yet presented for payment, are deducted from the aforesaid total.

(v) All the items of charges debited by the bank in the pass book but not entered in the cash book are added and all the credits given by the bank are deducted.

(vi) Adjustments for errors are made according to the principles of rectification of errors. (The rectification of errors has been discussed in Chapter 4)

(vii) Now the net balance shown by the statement should be the same as shown by the cash book.

If the bank pass book shows an overdraft, then the items added above will be deducted and the items deducted above will be added to arrive at the balance as per cash book.

The same treatment will be given to various items when the bank reconciliation statement starts with the debit balance as per cash book.

In the case of credit balance (overdraft) in the cash book, the reverse treatment will be given,

i.e. as was done in the case of balance as per bank pass book.

Generally, the bank reconciliation statement is prepared after passing adjustment entries in respect of all the items relating to errors and omissions. If this is done, the bank reconciliation statement will show only two categories of items:

(i) cheques deposited but not yet collected; and
(ii) cheques issued but not yet presented for payment.

The preparation of the bank reconciliation statement is illustrated below:

Illustration 1

The following particulars relate to the business of Arvind on May 31, 1988.

	Rs
Balance as shown by the cash book	11,000
Balance as shown by the bank pass book	11,200
Cheques issued but not yet presented for payment	1,300
Cheques deposited but not yet collected	1,100

Solution

The Bank Reconciliation Statement of Arvind as on May 31, 1988.

		Rs	Rs
Balance as per bank pass book			11,200
Add	Cheques deposited but not yet collected	1,100	1,100
			12,300
Less	Cheques issued but not yet presented for payment	1,300	1,300
	Balance as per cash book		11,000

Note. If more than one cheque is outstanding, details of all the cheques should be shown in the reconciliation statement

Illustration 2

The bank pass book of Messers Roy & Co. showed a balance of Rs.22,500 on May 31, 1988. But cheques issued before May 31, 1988, amounting Rs. 12,970, had not been presented for encashment. Two cheques of Rs. 1,950 and Rs. 1,175 were deposited into the bank on May 31, but the bank gave credit for the same in June. There was also a debit in the pass book of Rs. 1,250 in respect of a cheque dishonoured on May 31. Prepare a reconciliation statement as on May 31, 1988.

Solution

M/s Roy & Co

Bank Reconciliation Statement as on May 31, 1988

		Rs.	Rs.
Balance as per bank pass book			22,500
Add	Cheques deposited before May 31, but credited by the bank in June		
	Cheque No.	1,950	
	No.	1,175	
	The amount of a cheque dishonoured and not adjusted in the cash book	1,250	4,375
			26,875
Less:	Cheques issued but not presented before May 31	12,970	12,970
	Balance as per cash book		13,905

Illustration 3

On March 31, 1988, your bank pass book showed a balance of Rs. 16,000 to your credit. On March 29, 1988, you had issued cheques amounting to Rs. 11,500, of which cheques amounting to Rs. 1,900 have so far been presented for payment. A cheque for Rs. 1,800 paid by you into the bank on March 29 has not yet been credited in the pass book. You had also received a cheque for Rs. 1,160 which, although entered by you in the bank column of the cash book, was not deposited in the bank. On March 29 a cheque for Rs. 1,250, received by you was paid into the bank and the same was credited by the bank in your account but was not entered in the cash book. The bank credited interest amounting to Rs. 185 and debited Rs 10 for bank charges.

Draw up a reconciliation statement to reconcile the bank balance shown by your cash book with the balance shown by the bank pass book.

Solution

Bank Reconciliation Statement as on March 31, 1988

	Rs	Rs.
Balance as per bank pass book		16,000
Add. Cheques paid in but not yet credited by the bank	1,800	
Cheques not banked, though entered in the cash book	1,160	
Bank charges debited but not adjusted in the cash book	10	2,970
		18,970
Less: Cheques issued but not presented	9,600	
Cheques deposited in bank but not entered in the cash book	1,250	
Interest credited by the bank but not entered in the cash book	185	11,035
		7,935

Illustration 4

From the following particulars, you are required to ascertain the bank balance as would appear in the cash book of R. Chandran as on October 31, 1988.

1. The bank pass book showed an overdraft of Rs 16,500 on October 31.
2. Interest of Rs 1,250 on overdraft up to October 31, 1988, has been debited in the bank pass book, but it has not been entered in the cash book.
3. Bank charges debited in the bank pass book amount to Rs. 35.
4. Cheques issued, prior to October 31, 1988 but not presented till that date, amounted to Rs. 11,500.
5. Cheques paid into the bank before October 31, but not collected and credited up to that date, were for Rs. 2,500.
6. Interest on Investments collected by the bankers and credited in the bank pass book amounted to Rs. 1,800.

Solution

Bank Reconciliation Statement as on October 31, 1988

	Rs.	Rs.
Overdraft as per bank pass book		16,500
Add Cheques issued but not presented	11,500	
Interest on investments credited by the bank but not adjusted in the cash book	1,800	13,300
		29,800
Less. Interest on overdraft debited in the pass book but not entered in the cash book	1,250	
Bank charges debited in the pass book	35	
Cheques paid into the bank, but not yet collected	2,500	3,785
Bank overdraft as per cash book.		26,015

Demonstration Problem

Mr. M K Gupta started a new business. During the first month of operation, the following transactions took place.

<u>1989</u>

April	1	Mr. M K. Gupta paid Rs. 1,00,000 in cash as capital
	1	Purchased office equipment for cash Rs. 12,000
	2	Purchased a second hand car for cash Rs 42,000, for office use
	2	Paid Rs. 1,800 cash for a one-year insurance policy on the car
	8	Purchased goods on account for a total of Rs. 36,000
	15	Sold goods for cash Rs. 24,000
	17	Paid to creditors cash Rs. 20,000 for supply of goods
	28	Sold goods on credit for Rs 12,000
	30	Withdraw cash Rs. 1,000 for private use

30 Paid Rs. 1,500 as salary to an assistant employed on April 1, 1989.

Note:: Stock in hand on April 30, Rs. 12,000

Required

(i) Record the above transactions in the general journal.

(ii) Post the entries to the ledger accounts

Answer to Demonstration Problem (Folio numbers omitted)

(i) General Journal

Date		*Particulars*	*L.F.*	Debit *Rs.*	Debit *P*	Credit *Rs*	Credit *P*
1989 April	1	Cash Capital (Capital investment in the business)		1,00,000	-	1,00,000	-
	1	Office equipment Cash (Purchased Office equipment for cash)		12,000	-	12,000	-
	2	Office Car Cash (Purchased office car for cash)		42,000	-	42,000	-
	2.	Insurance for car Cash (Paid insurance premium for car for one year)		1,800	-	1,800	-
	8.	Purchases Creditors (Purchased goods on credit)		36,000	-	36,000	
	15	Cash Sales (Sold goods for cash)		24,000	-	24,000	-
	17	Creditors Cash (Paid cash to creditors)		20,000	-	20,000	-
	28.	Debtors Sales (Sold goods on credit)		12,000	-	12,000	-
	30	Drawings Cash (withdraw cash for private use)		1,000	-	1,000	-
	30	Salary Cash (Paid salary)		1,500	-	1,500	-

(ii) LEDGER

Cash

Date 1989		Particulars	Folio	Debit Rs	P	Date 1989		Particulars	Folio	Credit Rs	P
April	1	Capital		1,00,000	-	April	1	Office equipments		12,000	-
	15	Sales		24,000	-		2	Car		42,000	-
							2	Insurance for car		1,800	-
							17	Creditors		20,000	-
							30	Drawings		1,000	-
							31	Salary		1,500	-

Office Equipment

Date 1989		Particulars	Folio	Debit Rs	P	Date 1989		Particulars	Folio	Credit Rs	P
April	1	Cash		12,000	-						

Office Car

Date 1989		Particulars	Folio	Debit Rs	P	Date 1989		Particulars	Folio	Credit Rs	P
April	2	Cash		42,000	-						

Insurance for Car

Date 1989		Particulars	Folio	Debit Rs	P	Date 1989		Particulars	Folio	Credit Rs	P.
April	2	Cash		1,800	-						

Purchases

Date 1989		Particulars	Folio	Debit Rs	P	Date 1989		Particulars	Folio	Credit Rs	P
April	8	Creditors		36,000	-						

Debtors

Date 1989		Particulars	Folio	Debit Rs	P	Date 1989		Particulars	Folio	Credit Rs	P
April	28	Sales		12,000	-						

Creditors

Date 1989		*Particulars*	*Folio*	*Debit Rs*	*P*	*Date 1989*		*Particulars*	*Folio*	*Credit Rs*	*P*
April	17	Cash		20,000	-	April	8	Purchases		36,000	-

Capital

Date 1989		*Particulars*	*Folio*	*Debit Rs*	*P*	*Date 1989*		*Particulars*	*Folio*	*Credit Rs*	*P.*
						April	1	Cash		1,00,000	-

Drawings

Date 1989		*Particulars*	*Folio*	*Debit Rs.*	*P*	*Date 1989*		*Particulars*	*Folio*	*Credit Rs*	*P*
April	30	Cash		1,000	-						

Sales

Date 1989		*Particulars*	*Folio*	*Debit Rs*	*P.*	*Date 1989*		*Particulars*	*Folio*	*Credit Rs.*	*P*
						April	15	Cash		24,000	-
							28	Debtors		12,000	-

Salary

Date 1989		*Particulars*	*Folio*	*Debit Rs*	*P*	*Date 1989*		*Particulars*	*Folio*	*Credit Rs*	*P*
April	30	Cash		1,500	-						

SUMMARY WITH REFERENCE TO LEARNING OBJECTIVES

1. Meaning of Source Documents

Various business documents such as invoice, bills, cash memos, vouchers, which form the basis and evidence of a business transaction recorded in the books of account are called source documents.

2. Meaning of Accounting Equation

A statement of equality between debits and credits signifying that the assets of a business are always equal to the total of liabilities and owner's equity.

3. Rules of Debit and Credit

An account is divided into two sides. The left side of an account is known as Debit and the right side is known as Credit The rules of Debit and Credit depend on the nature of an account. Debit and Credit both may represent either increase or decrease, depending on the nature of an account. These rules are summarised below

Nature (Type) of an Account	*Debit*	*Credit*
Assets	Increase	Decrease
Liabilities	Decrease	Increase
Owner's equity (Capital)	Decrease	Increase
Revenues	Decrease	Increase
Expenses	Increase	Decrease

4. Description of Double Entry Book-keeping

A system of accounting in which every transaction affects at least two accounts on the opposite sides.

5. Meaning of Books of Original Entry

Those books in which a transaction is recorded for the first time from a source document The following are the important books of original entry ·

(i) *Journal*—Basic book of original entry.

(ii) *Cash Book*—A book used to record all cash receipts and payments.

(iii) *Petty Cash Book*— A book used to record small cash payments.

(iv) *Purchases Journal*—A special journal (day book) in which only credit purchases are recorded.

(v) *Sales Journal*—A special journal (day book) in which only credit sales are recorded.

(vi) *Purchases Returns Journal*—A special journal (day book) in which returns of merchandise purchased on credit are recorded.

(vii) *Sales Returns Journal*—A special journal (day book) in which returns of merchandise sold on credit are recorded

6. Meaning of Ledger

A book containing all the accounts to which entries are transferred from the books of original entry

Posting—A process of transferring entries from books of original entry to the ledger.
Balancing of account—Ascertaining the balance of an account after totalling all the debits and credits for a given period

g of Bank Reconciliation Statement

ıt prepared to reconcile the bank balance as per cash book with the balance as per ›ook or statement, by showing the ıtems of dıfference between the two accounts

TERMS INTRODUCED IN THE CHAPTER

ument	Purchases journal
; equation	Sales journal
	Purchases returns journal
	Sales returns journal
	Ledger
ɹy book-keeping	Posting
ɪrginal entry	Balancing of account
	Bank reconciliation statement

book

Choice Questions

ledger is a book of·
Original entry
Secondary entry
All cash transactions
Petty cash transactions
purchases journal contains·
All purchases
All purchases of merchandise
Credit purchase of merchandise
Cash purchase of merchandise
ch of the following is correct?
Capital = Asset + Liabilities
Liabilities = Capital − Assets
Liabilities = Capital + Assets
Capital = Assets − Liabilities
ɔrding of transaction in the journal is called :
Posting
Journalising
Tallying
Casting
ɜn a firm maintains a cash book, it need not maintain
Sales journal
Purchases journal
General journal
Cash account in the ledger
source document for recording entries in the purchases returns journal is generally·
A credit note
An invoice
A bill
A debit note

Fill in the Blanks

1 The source documents provide information about the nature of the ——— and the ——— involved in it
2 The accounting equation is a statement of ——— between the debits and credits.
3 An account is a formal record of ——— in items of ——— nature
4 The left side of an account is known as ——— and the right side as ———
5 In double entry book-keeping, every transaction affects at least two ———
6. The debit and credit both may represent either ——— or ———
7 The journal is the basic book of ——— entry
8 Recording of transactions in the journal is called ———
9 When a cash book is maintained, the transactions of cash are not recorded in the ———.
10 The word(c) against an entry in the cash book signifies that this entry is not to be——— to the ledger.
11 The petty cashier generally works on ——— system
12 In the purchases journal, all ——— purchases of merchandise are recorded
13 In the sales journal, all ——— sales of merchandise are recorded.
14 The process of transferring entries from books of original entry to the ledger is called———
15 Assets are always equal to liabilities plus ———

Questions

1 Explain the meaning of source documents with examples
2 Explain the meaning of the accounting equation.
3 Justify the statement that the Accounting Equation (A = L+C) holds good under all circumstances Give atleast two illustrations
4. Describe two basic purposes of source documents
5. What is owner's equity? Give an equation for calculating owner's equity.
6 Give the transactions that will·
 (i) Increase an asset and increase a liability
 (ii) Increase an asset and decrease another asset
 (iii) Decrease an asset and decrease capital
7 Explain the rules of debit and credit
8. Explain the meaning of double entry book-keeping
9. What are books of original entry?
10 What is a general journal?
11 Why is a journal sub-divided?
12 What is a special journal? Give a specimen of such a journal showing at least five entries
13 Explain that the cash book is a journal as well as a ledger account.
14 What do you understand by a 'contra entry'?
15 What do you understand by 'petty cash book'?
16 Explain the meaning and utility of a cash book
17. What is the meaning of an account?
18. What is the purpose of a ledger?
19 Explain the rules of debit and credit.
20 On which side of the account are the following decreases recorded
 (i) Assets
 (ii) Liabilities
 (iii) Owner's equity
 (iv) Revenues
 (v) Expenses

21 Indicate the nature (debit or credit) of normal balance in the following accounts
(i) Cash
(ii) Accounts receivable (debtors)
(iii) Accounts payable (creditors)
(iv) Furniture
(v) Merchandise
(vi) Capital
(vii) Miscellaneous expenses
(viii) Rent payable
(ix) Salaries paid
22. List the various subsidiary (special) journals.
What is the purpose of each subsidiary journals? Give specimen of the purchases journal and sales journal with four imaginary entries.
23. At the time of recording a transaction in the general journal, should the account (s) to be credited or debited be entered first?
24 Explain the meaning of posting.
25. Explain the meaning and purpose of the Ledger Folio (L F.).
26. What is a bank reconciliation statement? Why is the preparation of the bank reconciliation statement necessary?
27. Explain the reasons on account of which the balance as shown by the bank pass book does not agree with the balance as shown by the bank column of the cash book
28. How is a bank reconciliation statement prepared? Prepare a bank reconciliation statement with imaginary figures.

EXERCISES

1. Show the Accounting Equation on the basis of the following transactions:

		Rs.
(i)	Ram started business with cash	50,000
(ii)	Purchased goods from Shyam costing	20,000
(iii)	Sold goods to Sohan costing Rs. 3,000	3,600

2. Develop the Accounting Equation from the following transactions:

		Rs.
(i)	Mohan commenced business with cash	50,000
(ii)	Purchased goods for cash	30,000
(iii)	Purchased goods on credit	20,000
(iv)	Sold goods (cost Rs 10,000) for cash	12,000
(v)	Bought furniture on credit	2,000
(vi)	Paid cash to a creditor	15,000

3. Anil had the following transactions.
(i) Commenced business with cash Rs. 50,000
(ii) Purchased goods for cash Rs. 20,000 and credit Rs. 30,000
(iii) Sold goods for cash Rs. 40,000 costing Rs. 30,000
(iv) Rent paid in cash Rs. 500
(v) Rent outstanding Rs. 100
(vi) Bought furniture for Rs. 5,000 on credit
(vii) Bought refrigerator for personal use for cash Rs 5,000
(viii) Purchased building for cash Rs 20,000
Use the Accounting Equation to show the effect of the above transactions on his assets, liabilities and capital and show the final Accounting Equation.
4. How will the following items be dealt with while preparing the bank column of the cash book.
(i) Paid into bank Rs 2,000
(ii) Withdrew from bank for office use Rs. 3,000
(iii) Withdrew from bank for private use Rs. 1,500

5. Prepare a two-column cash book from the following transactions and post them to appropriate ledger accounts.

1989 March		Rs.
1	Cash balance	7,000
2	Bank balance (Dr.)	1,00,000
3	Cash sales	60,000
6	Rent paid by cheque	24,000
8	Cash deposited in bank	60,000
10	Wages paid	1,000
10	Rent paid	1,800
12	Received cheque from Ram	8,000
14	Goods purchased	4,000
16	Withdrawn from bank for office use	20,000
18	Issued cheque to Hari	14,000
20	Withdrawn cash for personal use	4,000
22	Received cheque from Shyam and deposited in bank	10,000
24	Shyam dishonoured the cheque	10,000
26	Furniture purchased and cheque issued	6,000
29	Received interest on investments by cheque	3,000
30	Paid salaries	4,800

6. Enter the following transactions in the column of the petty cash book. The imprest is Rs 500

1989 March		Rs
1	Chowkidar's wages	18.75
2	Pencils	6.50
8	Postage stamps	24.00
12	Telegrams	36 00
14	Cartage	19.00
15	Scooter fare to assistant	14.00
20	Taxi fare to manager	64.00
24	Refreshment for customer	22.00
25	Writing pads and registers	80 00
27	Bus fare to peon	3.00
28	Cartage	14.00
29	Postage stamps	18.00
29	Telegrams	22 00
30	Casual workers	36 00
30	Repair of typewriter	35.00
31	Sundry expenses	12.00

7. M S. Brothers carry on business as wholesale cloth dealers. From the following, write up, their purchases book for January, 1988:

January

3 Purchased on credit from Ambika mills :
100 pieces long cloth @Rs 30
50 pieces shirting @Rs. 50

8 Purchased for cash from Arvind Mills.
50 pieces muslin @Rs. 40

15 Purchased on credit from India Textiles Ltd.
20 pieces suiting @Rs. 100
10 pieces shirting @Rs 60

20 Purchased 5 typewriters on credit from
Bharat Typewriter Ltd. @Rs. 1400 each.

8 From the following particulars, prepare the sales book of Akbar & Co., who deals in furniture:

June, 1989

5 Sold on credit to Anand & Co :
10 tables @Rs 300
20 chairs @Rs. 150

10 Sold to Bannerji & Co on credit
5 almirahs @ Rs 1500
5 stools @Rs 100

20 Sold old typewriter for Rs. 600 to Mohan and Co. on credit

25 Sold to Ram Lal & Bros on credit
5 tables @Rs 500
1 revolving chair @Rs 600

9. Enter the following transactions of Anil & Co. in the proper books

July

5 Sold on credit to Sethi & Co :
10 electric irons @Rs 25
5 electric stoves @Rs. 15

8 Purchased on credit from Hari & Sons
25 heatres @Rs 40
10 water heaters @Rs 20

10 Purchased for cash from Mohan &Co
10 electric kettles @Rs 30

15 Sold to Gopal Bros on credit :
10 heaters @Rs 50
5 water heaters @Rs. 25

18 Returned to Hari & Sons
5 heaters, being defective

20 Purchased from Kohli & Co
10 toasters @Rs 20
10 water heaters @Rs. 30

26 Gopal Bros. returned one water heater as defective

10 Record the following transactions in the concerned book viz,

(1) General journal, (2) Double column cash book (cash and bank), (3) Purchases journal, (4) Sales journal

(i) Ram started business with cash Rs 1,50,000 (ii) He deposited Rs. 1,30,000 in a newly opened bank account (iii) He purchased goods for cash Rs 8,000 (iv) He purchased goods for Rs. 10,000, payment was made through bank (v) He withdrew Rs 2,000 from the bank for office use (vi) He withdrew Rs. 1,000 from the bank for personal use (vii) He sold goods for cash Rs. 15,000 out of this he again deposited Rs. 12,000 in the bank (viii) He paid salary in cash Rs 200 (ix) He gave a cheque for rent Rs 300. (x) Sold goods on account to Y, Rs. 8000 (xi) Purchased goods on account from X, Rs 5,000 (xii) Sold goods for cash Rs 1,000 (xiii) Purchased goods from Z for cash Rs 2,500 (xiv) Purchased goods for cash Rs. 2,800 (xv) Cash paid to X, Rs 3,000 (xvi) Cash received from Y, Rs. 1600 (xvii) Machinery purchased for cash Rs 20,000 (xviii) Machinery purchased from Anil on account Rs 30,000 (xix) Sold a machine to Satish for cash Rs. 5,000 There was a loss on sale of Rs. 1,000 (xx) Interest earned Rs. 5,400 (xxi) Interest paid Rs 1200

11 From the following particulars, prepare a bank reconciliation statement showing the balance as per bank pass book on March 31, 1989

The following cheques were paid into the firm's current account in March 1989, but were credited by the bank in April, 1989 :

A Rs 2,500, B Rs. 3,500, and C Rs 1,900

The following cheques were issued by the firm in March, 1989 and were cashed in April, 1989

P Rs. 2,500; Q Rs 4,500, and R Rs 4,000

A cheque for Rs 1,000 which was received from a customer was entered in the bank column of the cash book in March, 1989, but the same was paid into the bank in April, 1989.

The pass book shows a credit of Rs 2,500 for interest and a debit of Rs 1,000 for bank charges The balance as per cash book was Rs 1,80,000 on March 31, 1989

12 The bank pass book of Mr X showed an overdraft of Rs. 33,575 on March 31, 1989 On going through the pass book,the accountant found the following:

(i) A cheque of Rs 1,080 credited in the pass book on March 28, being dishonoured, was debited again in the pass book in April, 1989. There was no entry in the cash book about the dishonour of the cheque until April 15

(ii) Bankers had credited his account with Rs 2,800 for interest collected by them on his behalf, the same has not been entered in his cash book

(iii) Out of Rs 20,500 paid in by Mr. X in cash and by cheques on March 31, cheques amounting to Rs 7,500 were collected by bank on April 7.

(iv) Out of cheques amounting to Rs 7,800 drawn by him on March 27, a cheque for Rs 2,500 was encashed on April 3 Prepare bank reconciliation statement on March 31, 1989

13. From the following particulars, prepare a bank reconciliation statement showing the balance as per bank pass book on December 31, 1988 :

The following cheques were paid into the firm's bank account in December 1988, but were credited by the bank in January 1989 .

	Rs.
S M Bannerjee	2,000
S P Gupta	3,100
R A Kalra	1,800

The following cheques were issued by the firm in December, 1988, but were presented for payment in January 1989 :

	Rs.
A P Sharma	4,000
N A Dua	5,000
S.B Agarwal	3,420

A cheque for Rs 1,000 which was received from a customer in full settlement of his account was entered in the bank column of the cash book in December 1988 but the same was paid into the bank in January 1989

The bank balance as per cash book was Rs 19,900 on December 31,1988.

14 On December 31, 1988, your bank pass book showed a credit balance of Rs 15,010 Before that date, you had issued cheques amounting to Rs. 12,000 but they were not presented for payment. A cheque for Rs 1,500 paid by you into the bank was not credited. On December 31, 1988, you had also received a cheque for Rs 1,100, which, though entered in the cash book, was not paid into the bank. Besides, there was an entry of Rs. 175 for interest to your credit Draw up a bank reconciliation statement to determine the bank balance as per cash book.

15 Prepare a bank reconciliation statement from the following particulars as on March 31, 1989.

	Rs
Balance as per cash book	4,750
Cheques issued but not presented for payment till March 31	2,100
Cheques paid into the bank but not yet cleared	1,200
Interest allowed by the bank but no entry appeared in the cash book	120
Bank charges not entered in the cash book	80

16. From the following particulars, prepare a bank reconciliation statement showing the balance as per bank pass book as on December 31, 1988 :

	Rs
Debit balance as per cash book	19,820
The following cheques were issued by the firm in December but were presented for payment in January 1989 ·	
Sh. Rajni Deshmukh	6,840
Sh. C.D. Patel	7,068
Sh. D. Natarajan	4,535

The following cheques were sent to the bank for collection in December but were credited in the account in January 1989 ·

	Rs
Sh. Rajesh	3,200
Sh Mukesh	6,750
Sh Kamaljeet	5,340

A customer directly deposited in the firm's account Rs 3,200 The bank paid Rs. 400 insurance premium which was not entered in the cash book.

The bank allowed half yearly interest of Rs 85 and charged Rs 60 for its services, but the same were not entered in the cash book.

17. On March 31, 1989, the pass book of India Traders showed a debit balance of Rs 2,820. On checking the entries in the cash book with the bank pass book, it was ascertained that cheques of Rs. 18,700 were paid into the bank in the month of March but cheques of Rs 12,600 only were realised till March 31 and that out of cheques of Rs 12,700 issued on March 25, cheques of Rs 7,300 were cashed in April 1989 A cheque of Rs. 1,800 paid into the bank was returned dishonoured but no intimation was received from the bank till March 31. Another cheque of Rs. 1,300 was entered in the cash book in March but was sent to the bank in April 1989 The bank has debited Rs 120 for interest and Rs. 40 for bank charges.

    Prepare the bank reconciliation statement as on March 31, 1989

18. Prepare a bank reconciliation statement showing the balance as per cash book as on March 31, 1989, from the following particulars ·

Rs. 750 paid by the bank for insurance premium under a standing order of the account holder had not been entered in the cash book.

A customer paid Rs 2,400 directly into the bank account but advice from the bank was not received till March 31

Out of cheques issued for Rs 9,800 in March, cheques of Rs 4,300 only were cashed before March 31.

Cheques of Rs. 16,400 were paid into the bank in March out of them, cheques of Rs. 8,200 were credited in April and one of Rs. 700 was returned dishonoured.

An amount of Rs. 1200 paid into the bank was not entered in the cash book.

Rs. 400 collected by the bank as interest on investments was not entered in the cash book

There was a credit in the pass book of Rs. 240 for interest and a debt of Rs. 70 for bank charges These amounts did not find a place in the cash book.

The balance as shown by the pass book on March 31,1989, was Rs. 18,000

19 The following data pertain to Janta Traders

1 Balance as per the bank statement dated March 31, 1989, is Rs. 8,900.
2. Deposit of Rs. 2,600 on March 31 was not included in the bank statement

3. Cheques issued but not presented as of March 31, totalled Rs 2,100
4. The bank erroneously debited Janta Trader's Account for a cheque of Rs. 400
5. During March, the bank credited the account with the proceeds of a cheque for Rs 2,020 that it received directly for Janta Traders
6. Service and collection charges for the month amounted to Rs 20

Prepare a bank reconciliation statement as on March 31, 1989

20 The following are the extracts from the cash book (bank column only), and bank pass book of P D Gupta Prepare a reconciliation statement as on December 31, 1988

CASH BOOK (BANK COLUMN ONLY)

Dr. Cr

Date 1988		Particulars	Bank Rs	P	Date 1988		Particulars	Bank Rs	P
Dec.	1	Balance b/d	13,900	00	Dec.	3	Wages	1,400	00
,,	4	D D Sharma	1,700	00	,,	5	Petty cash	410	00
,,	7	Zaveri & Co,	1,760	00	,,	6	Interest	120	00
,,	9	Dogra Bros	1,250	00	,,	8	Self (private)	1,300	00
,,	11	Int on securites	1,400	00	,,	11	Bank charges	10	25
,,	28	T Rao & Co	1,620	00	,,	14	S Vaidya	1,700	00
,,	29	R Das & Sons	1,600	00	,,	18	Wages	1,400	00
,,	30	V K Goel	2,200	00	,,	27	S Shah & Co	2,080	00
,,	31	A. Sen	4,300	00	,,	31	Salaries	2,180	00
					,,	31	Wages	1,400	00
					,,	31	Joshi & Joshi Associates	1,730	00
					,,	31	Balance c/d	15,999	75
			29,730	00				29,730	00
1989 Jan.	1	Balance b/d	15,999	75					

BANK PASS BOOK

Name P. D. Gupta Address

Account No

Date 1988		Particulars	Dr Rs.	P	Cr Rs.	P	Dr /Cr.	Balance Rs	P	Init
Dec.	31	B/F			10,089	75	Cr	10,089	75	
1989 Jan.,	1	Joshi & Joshi Associates	1,730	-						
		T Rao & Co			1,620	-				
,,	3	Commission on Calcutta draft	5	-						
,,	3	Self	400	-						
,,	3	R Das & Sons			1,600	-				
,,	4	K. Kanwar	225	-						
,,	5	S. Shah & CO	2,080	-						
,,	5	A. Sen			4,300	-				
,,	6	Commission on Delhi cheque	10	-						
,,	6	Cash			400	-				
,,	6	V K. Goel			2,200	-				

ANSWERS

Multiple Choice

1 (2)
2 (3)
3 (4)
4 (2)
5 (4)
6. (4)

Fill in the blanks

1 Transaction, amount
2 Equality
3 Changes, items of similar nature
4 Debit, credit
5 Accounts
6 Increase, decrease
7. Original
8. Journalising
9 Journal
10 Posted
11 Imprest
12 Credit
13 Credit
14. Posting
15 Owner's equity

Exercises

1. Asset Rs 70,600 = Liabilities Rs. 20,000+Capital Rs.50,600
2 Assets Rs 59,000 = Liabilities Rs. 7,000+Capital Rs. 52,000
3. Assets Rs. 89,500 = Liabilities Rs. 35,100+Capital Rs 54,400
5 Balance cash Rs 11,400. Bank (Dr) Rs. 1,07,000
6 Petty cash balance Rs 75.75
7 Total of purchases book Rs. 8,100
8. Total of sales book Rs 17,100
9. Total of sales book Rs 95, purchases book Rs 1,700.
Returns outwards book Rs. 200; Returns inwards book Rs. 25.

11	Balance as per bank pass book	Rs	1,83,600
12	Overdraft as per cash book	Rs.	31,375
13.	Balance as per bank pass book	Rs	24,420
14	Balance as per cash book	Rs	5,435
15.	Balance as per pass book	Rs.	5,690
16.	Balance as per pass book	Rs.	25,798
17.	Overdraft as per cash book	Rs	760
18.	Balance as per cash book	Rs.	17,980
19	Balance as per cash book	Rs.	7,800

CHAPTER 4

TRIAL BALANCE AND ERRORS

LEARNING OBJECTIVES

After studying this chapter, you should be able to :

* explain the meaning of Trial Balance;
* determine the objectives of the Trial Balance;
* prepare the Trial Balance by the balance method;
* explain the meaning of various types of errors;
* rectify errors by passing journal entries;
* explain the meaning and utility of the Suspense Account; and
* prepare and dispose of the Suspense Account.

IN THE PREVIOUS CHAPTER we have learnt how to prepare ledger accounts. One very important aspect of the double entry accounting system is that for each transaction there is debit and credit of equal amounts in two or more accounts. Thus, the total of the debit balance must be equal to the total of the credit balance Now we shall learn the method of verifying the correctness of posting to ledger accounts in terms of the debit and credit amounts, by preparing a Trial Balance.

4 1 MEANING OF TRIAL BALANCE

The Trial Balance is a statement showing the balances, or total of debits and credits, of all the accounts in the ledger with a view to verifying the equality of debits and credits posted to the ledger accounts. If the totals of the debit and credit amount columns of the Trial Balance are equal, it is presumed that the posting to the ledger in terms of debit and credit amounts is accurate.

A Trial Balance may be prepared at any time but it **must** be prepared at the close of the accounting year.

As mentioned above, a Trial Balance can be prepared in two ways, viz·

1. showing balances, and
2. showing total amounts of debit and credit in each ledger account

However, the first type of Trial Balance is more common. Both types of Trial Balance with imaginary figures are illustrated below·

X and Co.

Trial Balance as on March 31, 1988

Account	*Type 1* (*Debit and credit balance only*)		*Type 2* (*Total debits and total credits*)	
	Debit Rs	Credit Rs	Debit Rs	Credit Rs
Capital		50,000		50,000
Fixed assets	12,000		14,000	2,000
Cash	41,733		1,74,180	1,32,447
Debtors	24,436		1,47,140	1,22,704
Merchandise	4,000		1,15,850	1,11,850
Creditors		8,553	1,07,297	1,15,850
Sales		1,46,616	524	1,47,140
Cost of goods sold	1,10,850		1,10,850	
Expenses	12,150		12,150	
Total	2,05,169	2,05,169	6,81,991	6,81,991

4.2 OBJECTIVES OF THE TRIAL BALANCE

The following are the objectives of preparing the trial balance:

(a) To ascertain the arithmetical accuracy of the ledger accounts.

(b) To help in locating errors.

(c) To help in the preparation of the final accounts

4.2.1. To Ascertain the Arithmetical Accuracy of Ledger Accounts

It was stated earlier that if the sum of the debit and credit columns of the trial balance is equal, it is assumed that the posting to the ledger accounts is accurate However, the equality of debits and credits of the Trial Balance does not mean that the individual ledger accounts are also accurate. It is possible that postings of correct amounts might have been made to wrong accounts or an entry might have been omitted in the journal or subsidiary books.

The tallying of the Trial Balance is not conclusive proof of the accuracy of the ledger accounts It only indicates that equal debits and credits have been recorded in the ledger accounts and the balances of accounts have been correctly calculated. There may be a number of errors which are not revealed by the Trial Balance. These also constitute the limitations of the Trial Balance. For example, an error may be committed by entering a wrong amount on either or both sides of an account or one error in posting and the other in totalling etc. Such errors can be avoided by exercising due care and caution in recording postings of transactions.

4.2.2 To Help in Locating Errors

When there are a large number of postings in a ledger and the Trial Balance does not tally, the accountant is faced with the problem of locating and correcting the errors. Even a small difference is to be given the same importance and attention as a large difference, due to the possibility of offsetting errors resulting in a small composite difference Thus, when a Trial Balance does not tally, steps may be taken to locate the errors. Various steps are taken by the accountant to locate the errors. These include:

1. A recheck of the tally of debits and credits of the Trial Balance.
2. A recheck of the Trial Balance items with the ledger.
3. To look for items in the books of original entry which do not have the ledger folio.
4. A difference in one of the digits may be due to error in totalling/addition and balancing the ledger accounts. A recheck of the totals of the ledger accounts and their balancing should be undertaken.
5. If the difference is divisible by 2, it is possible that a posting of the amount equal to one half of the difference may have been made on the wrong side of a ledger account For example, if the total of the debit side of the Trial Balance exceeds by Rs.1,254, it is possible that due to a mistake, a credit item of Rs.627 has been posted in the ledger as a debit. The accountant should scan all the entries of the amount of Rs.627.
6. The difference may also indicate a complete omission of a posting For example, the difference of Rs.1,254 just mentioned in (5) above, may be due to omission of a posting of that amount on the credit side The accountant should scan all the entries of the amount of Rs.1,254
7. If the difference is of two digits (excluding zeros) and their sum is a multiple of 9, the mistake would have been in the **transposition** of figures. For example, if a debit of Rs. 395 has been posted as Rs.359, the credit side of the Trial Balance will exceed by Rs.36. Thus, a difference in the Trial Balance divisible by 9 may help in detecting the error by re-examining the entries A mistake due to wrong placement of the decimal point may also be identified by this method.

4.2.3 To Help in the Preparation of the Final Accounts

As stated earlier, the Trial Balance contains the list of all the ledger accounts with their debit and credit balances. This facilitates further processing of accounting data, i e. preparation of the Final Accounts (financial statements). For preparing a financial statement, one need not refer to the ledger. In fact, the availability of a tallied Trial Balance is the first step in the preparation of financial statements. All revenue and expense accounts appearing in the Trial Balance are transferred to the Trading and Profit and Loss Account All assets, liabilities and capital accounts are transferred to the Balance Sheet. (Preparation of the financial statement is explained in Chapter 5)

4.3 PREPARATION OF THE TRIAL BALANCE

4.3.1 By Balance Method

To prepare the Trial Balance by the balance method, all the ledger accounts are first balanced. This work is done immediately after completion of postings from books of original entry to the ledger. Balancing of an account means to equalise both the sides of an account by putting the difference between the totals of two sides of an account on the shorter side, as explained earlier. When all the accounts have been balanced, the Trial Balance can be prepared. The Trial Balance has three columns. The first column is for the account name, and the second and third columns are for the amount of debit and credit balances respectively. See pages 82, 83 and 84.

4.3.2 Total Amounts Method

The Trial Balance under this method is prepared in the same way as in the 'Balance Method' with the difference that in this method, the totals of debits and credits, instead of the balances of each account are shown in the Trial Balance, as illustrated earlier on page 79.

4.4 ERRORS

As stated earlier, the tallying of the Trial Balance does not mean that no errors have been committed in the accounting records. There can be errors which do not affect the equality of debits and credits, and there can be errors which affect the equality of debits and credits.

Keeping in view the nature of errors, all the errors can be classified into the following four categories:

(a) Errors of commission
(b) Errors of omission
(c) Errors of principle
(d) Compensating (offsetting) errors

4.4.1 Errors of Commission

These are errors which are caused due to wrong posting (either of an amount or on the wrong side of an account, or in the wrong account), wrong totalling, wrong casting of the subsidiary books, wrong balancing, wrong recording of amount in the books of original entry, etc

For example, suppose Rs.5,000 is paid to a supplier and the same is correctly recorded in the cash book. But while posting to the ledger, the supplier's account is debited with Rs.500 only This is an error of commission. Most of the errors of commission are reflected in the Trial Balance.

4.4.2. Errors of Omission

The errors of omission can be committed in the recording of a transaction in the books of original entry or posting to the ledger. An omission may be complete or partial. Such omissions are known as errors of omission.

For example, suppose Rs 500 is paid to a supplier. In the cash book, the entry is made on the credit side but posting to the supplier's account in the ledger is omitted. This is an error of omission. Errors due to entire omission will not affect the Trial Balance whereas errors due to partial omission will affect the Trial Balance.

4.4.3 Errors of Principle

Errors of principle are committed when an accounting principle relating to proper distinction between capital and revenue items is

Illustration

Given below is a ledger extract. All the accounts have been classified under the headings assets, liabilities and owner's equity, to be in consonance with the accounting equation explained earlier in Chapter 3. You are required to prepare the Trial Balance by the balance method.

Assets = *Liabilities* + *Owner's equity*

Cash

	(Rs.)		(Rs.)
Capital	50,000	Fixed Assets	14,000
Fixed Assets	2,000	Expenses	12,150
Debtors	1,22,180	Creditors	1,06,297
		Balance c/d	41,733
	1,74,180		1,74,180
Balance b/d	41,733		

Fixed Assets

	Rs.		Rs
Cash	14,000	Cash	2,000
		Balance c/d	12,000
	14,000		14,000
Balance b/d	12,000		

Creditors

	(Rs.)		(Rs.)
Cash	1,06,297	Purchases	1,15,850
Purchases returns	1,000		
Balance c/d	8,553		
	1,15,850		1,15,850
		Balance b/d	8,553

Capital

	(Rs.)		(Rs.)
Balance c/d	50,000	Cash	50,000
	50,000		50,000
		Balance b/d	50,000

Sales

	Rs		Rs.
Debtors returns	524	Debtors	1,47,140
Balance c/d	1,46,616		
	1,47,140		1,47,140
		Balance b/d	1,46,616

Assets	=	*Liabilities*	+	*Owner's equity*

Debtors

	Rs.		Rs.
Sales	1,47,140	Sales return	524
		Cash	1,22,180
		Balance c/d	24,436
	1,47,140		1,47,140
Balance b/d	24,436		

Merchandise

	Rs.		Rs
Creditors	1,15,850	Returns	1,000
		Cost of goods sold	1,10,850
		Balance c/d	4,000
	1,15,850		1,15,850
Balance b/d	4,000		

Cost of goods sold

	Rs		Rs.
Merchandise	1,10,850	Balance c/d	1,10,850
	1,10,850		1,10,850
Balance b/d	1,10,850		

Expenses

	Rs		Rs
Cash	12,150	Balance c/d	12,150
	12,150		12,150
Balance b/d	12,150		

Trial Balance, as on March 31, 1988

Account Name	*Debit* Rs	*Credit* Rs.
Cash	41,733	
Fixed assets	12,000	
Debtors	24,436	
Merchandise	4,000	
Creditors		8,553
Capital		50,000
Purchases	1,10,850	
Sales		1,46,616
Expenses	12,150	
	2,05,169	2,05,169

violated while recording a transaction in the books of account. (For distinction between capital and revenue, see Chapter 5.) In other words, these errors arise due to incorrect allocation of expenditure or receipt between capital and revenue. The correct allocation between capital and revenue is of great importance because incorrect allocation would disturb the final results shown by the financial statements.

For example, when a second hand machine is purchased and before it is put to use, some amount is spent on its repair and overhauling. The amount so spent is to be debited to the machine account and not the Repairs Account. If by mistake, the amount is debited to the Repairs Account, it will be considered an error of principle.

Another example of error of principle is when fixed assets purchased are debited to the Purchases Account or their sale is credited to the Sales Account instead of debiting and crediting fixed assets respectively.

These errors are also not disclosed by the Trial Balance.

4.4.4 Compensating Errors

When two or more errors are committed in such a way that the net effect of these errors on the debits and credits of accounts is nil, such errors are called compensating errors.

For example, while debiting an account, it i debited with Rs. 720 instead of Rs. 270, thus over debiting it with Rs. 450 and while crediting som other account, it is over-credited by exactl Rs. 450. These two mistakes will nullify th effect of each other. Such errors are termed a compensating errors. These errors do not affec the tallying of the Trial Balance.

Another example of compensating errors ma be—

A credit purchase of Rs.2,510 from Mr.X i credited to his account as Rs.5,210, whereas a credit sale of Rs 3,633 to Mr.Y is debited to hi account as Rs.6,333. As a result of these errors there is excess credit of Rs.2,700 in X's accoun and excess debit of Rs.2,700 in Y's account.

4.5 RECTIFICATION OF ERRORS

When a Trial Balance does not tally, it is a clear indication that one or more errors have been made. When errors are located, they have to be rectified.

(a) Classification

From the view point of rectification, all errors may be classified into the following two categories:

(i) Errors which Affect the Trial Balance

These errors are only in one account. They can be rectified by giving an exaplanatory note or by passing a journal entry with the help of the Suspense Account, depending on the stage at which the errors are rectified. (Suspense Account is explained later in this Chapter). Examples of such errors are error of casting; error of carrying forward; error of balancing; error of posting to correct account but with wrong amount; error of posting to the correct account but wrong side; posting to the wrong side with the wrong amount; omitting to show an account in the Trial Balance.

An error in the books of original entry, if discovered before it is posted to the ledger, may be corrected by crossing out the wrong amount by a single line and writing the correct amount above the crossed amount and initialling it. An error in an amount posted to the correct ledger account may also be corrected in a similar way, or by making an additional posting for the difference in amount and giving an explanatory note in the particulars column. But errors should never be erased because erasures reduce the authenticity of accounting records and give an impression that something is being concealed.

Examples

(i) The sales journal is undercast (totalled less) by Rs.100

The total of sales journal is posted to the Sales Account. Assuming that the customers' accounts have been debited correctly, the **mistake** lies in the Sales Account only. To rectify this error, the Sales Account may be further credited with Rs.100, saying

"Mistake in totalling the
sales journal on page ——"

Errors of carrying forward or balancing can also be rectified in a similar manner.

(ii) An amount of Rs.595 for credit purchases from Anil on 15.3.1988, correctly entered in the purchases journal, has been credited to his account as Rs 559, thus, under-crediting him with Rs. 36.

In this case, assuming that the purchases account has been posted correctly, the **mistake** lies in Anil's account only. This error can be rectified by further crediting Anil's account with Rs.36 with an exaplanatory note in the particulars column as under:

"Mistake in posting on 15 3 1988'.

(iii) An amount of Rs 250 for credit purchases on 18.3.88 from S.K. Dhingra, correctly entered in the purchases book, has been debited to him instead of being credited to his account.

Here again, assuming that the purchases account has been posted correctly the **mistake** lies in Dhingra's account only. The error can be rectified by crediting his account with Rs.500 with the explanatory note.

"Mistake in posting on 18.3.88".

(ii) Errors which do not Affect the Trial Balance

Such errors are committed in two or more accounts They can be rectified by passing a journal entry giving the correct debit and credit to the concerned accounts. Examples of such errors are— omission to pass an entry in the books of original entry, wrong recording or transactions in the books of accounts; posting to the wrong account on the correct side; and errors of principle

These errors are corrected by passing a journal entry, as illustrated below:

Suppose the following entry has been made in the journal in respect of an amount received from Ram & Co. and it has been posted accordingly,

	Debit Rs.	Credit Rs.
Cash	1,245	
Ram & Sons		1,245

In the above case, credit has been given to Ram & Sons instead of Ram & Co. To rectify the above error, the following correcting journal entry will have to be passed and posted to the respective accounts.

	Debit Rs.	Credit Rs
Ram & Sons	1,245	
Ram & Co.		1,245

(To correct the wrong credit given to Ram & Sons instead of Ram & Co.).

Another example of rectification of errors by passing a journal entry when the Trial Balance is not affected is given below:

Purchase of office equipment on credit for Rs.2,500 has been entered in the purchases journal.

In this case, the total of purchases journal will be debited to purchases account resulting in an excess debit of Rs.2,500, whereas purchase of office equipment should have been debited to the office equipment account. The supplier's account will be correctly credited. To rectify this error, the following journal entry will be passed:

	Debit Rs.	Credit Rs.
Office Equipment	2,500	
Purchases		2,500
(To correct the wrong recording of purchases)		

4.6 SUSPENSE ACCOUNT

4.6.1 Meaning

In case the Trial Balance does not tally, it indicates that some errors have been comitted. It is essential to locate and rectify errors, otherwise the financial statements (profit and loss account and balance sheet) cannot be prepared correctly. However, many times in spite of the best efforts of the accountant, errors are not located. In such a situation, to avoid delay in the preparation of financial statements, the amount of difference of the Trial Balance is put in an account named 'Suspense Account' and the Trial Balance is tallied. If the Trial Balance is short of an amount on the debit side, the difference will be put in the debit side of the Suspense Account by writing the difference in the Trial Balance and vice versa. Generally, during the course of preparation of financial statements, errors are located and they are then corrected through the Suspense Account. When all the errors have been located, the Suspense Account will automatically stand balanced (closed). But if some balance remains outstanding in the Suspense Account, it will be shown in the Balance Sheet on the assets side (if debit balance) or on the liabilities side (if credit balance) depending on the nature of the balance. This indicates that certain errors are still to be located and rectified Subsequently, when all the errors have been located, the Suspense Account will stand closed. **It may be noted that the Suspense Account is used to rectify those errors which affect the Trial Balance.**

4.6.2 Utility of Suspense Account

It facilitates the preparation of financial statements even when the Trial Balance has not tallied. Later, when the errors affecting the Suspense Account are located, rectification entries are passed with the help of the Suspense Account.

4.6.3 Preparation and Disposal of Suspense Account.

The preparation and disposal of the Suspense Account as explained above, can be understood with the help of the following illustrations:

Illustration 1

An accountant of a trading concern has not been able to tally the Trial Balance. The total of the debit side exceeded by Rs.6,350. With a view to avoid delay in the preparation of financial statements, he opened the Suspense Account by putting the difference on its credit side and tallied the Trial Balance by entering the Suspense Account in the Trial Balance. Later, the following errors were discovered:

(a) Sale of goods of Rs.200 was entered in the sales book as Rs.2,000.

(b) Sale of goods to Ram Lal of Rs.550 was posted as Rs.5,500
(c) Sales book was overcast by Rs.2,000
(d) Purchases book was overcast by Rs.800.
(e) Total of purchases returns book was carried forward as Rs 1,220 instead of Rs.1,120.
(f) Entry for purchase of furniture for Rs.3,000 from Modern Furniture House was made in the purchases book. While making a posting, Modern Furniture House was credited with Rs.300.

You are required to pass journal entries to rectify the errors and prepare the Suspense Account. Narration not required.

Solution

Journal

Date	Particulars	L.F.	Debit Rs	Credit Rs
	(a) Sales		1,800	
	Debtors			1,800
	(b) Suspense		4,950	
	Ram Lal			4,950
	(c) Sales		2,000	
	Suspense			2,000
	(d) Suspense		800	
	Purchases			800
	(e) Purchases Returns		100	
	Suspense			100
	*(f) (i) Furniture		3,000	
	Purchases			3,000
	(ii) Suspense		2,700	
	Modern Furniture House			2,700

* There can be a composite entry also.

Suspense Account

	Debit Rs		Credit Rs.
3 Modern Furniture House	2,700	Difference in Trial Balance	6,350
1 Ram Lal	4,950	Sales	2,000
2 Purchases	800	Purchases Returns	100
	8,450		8,450

The above illustration shows that only those errors which affected the Trial Balance have been corrected with the help of the Suspense Account. Other errors (a and f(i)) have been corrected without involving the Suspense Account. Moreover, in the above illustration, since all the errors have been located and rectified, the Suspense Account stands disposed of.

Illustration 2

The Trial Balance of Mr. Gupta prepared as on December 31, 1988 did not tally. The difference was put in the Suspense Account. An examination of the books reveals the following :

(i) Rs. 10,800 paid to Rajiv Arora was posted to the credit of his account.
(ii) Rs. 500, being sales returns, was posted to the credit of Sales Account.
(iii) Discount of Rs. 200 received was posted to the debit of Discount Account.
(iv) Rs. 1,740 paid for repairs to motor car was debited to Motor Car Account as Rs. 2,740
(v) Rs. 8,000 paid to S.N Duggal was debited to S.N. Dhingra.

You are required to give journal entries to rectify the above errors and ascertain the amount transferred to the Suspense Account on December 31, 1988 by preparing the Suspense Account.

Solution

Journal

Date		Particulars	L F	Debit Rs.	P.	Credit Rs	P.
1988 December	31	Rajiv Arora Suspense (Amount paid to Rajiv Arora was Credited to his account, now rectified)		21,600	-	21,600	-
	31	Sales Sales returns Suspense (Sales returns were wrongly credited to sales, now rectified)		500 500	- -	1,000	-
	31	Suspense Discount (Discount received was debited, now rectified)		400	-	400	-
	31	Repairs to motor car Suspense Motor car (Expenses on motor car repairs Rs 1,740, were debited to motor car as Rs 2,740, now rectified)		1,740 1,000	- -	2,740	-
	31	S N. Duggal S.N.Dhingra (Amount paid to S N Duggal was debited to S.N. Dhingra, now rectified)		8,000	-	8,000	-

Suspense Account

Dr. Cr.

Date 1988		Particulars	L.F	Debit Rs.	P	Date 1988			L F.	Credit Rs	P
Dec.	31	Difference in the Trial Balance (Balancing figure)		21,200	-	Dec.	31	Rajiv Arora		21,600	-
						Dec.	31	Sales		500	-
						Dec	31	Sales returns		500	-
Dec.	31	Discount		400	-						
Dec	31	Motor car		1,000	-						
				22,600	-					22,600	-

Demonstration Problem

Prepare a Trial Balance as on April 30, 1989, from the demonstration problem of M.K. Gupta given in Chapter 3 on page 64.

Solution

M.K. Gupta

Trial Balance as on April 30,1989.

Account Name	*Debit* *Rs.*	*P*	*Credit* *Rs*	*P*
Cash	45,700	-		
Office equipment	12,000	-		
Office car	42,000	-		
Iinsurance for car	1,800	-		
Purchases (Goods)	36,000	-		
Debtors	12,000	-		
Creditors			16,000	-
Capital			1,00,000	-
Drawings	1,000	-		
Sales			36,000	-
Salary	1,500	-		
Total	1,52,000	-	1,52,000	-

Note Stock in hand on April 30, 1989 · Rs 12,000

SUMMARY WITH REFERENCE TO LEARNING OBJECTIVES

1. Meaning of Trial Balance

A statement showing the abstract of the balance (debit/credit) of various accounts in the ledger.

2. Objectives of Trial Balance

The main objectives of preparing the Trial Balance are (i) to ascertain the arithmetical accuracy of the ledger accounts; (ii) to help in locating errors, and (iii) to help in the preparation of the Final Accounts.

3. Preparation of Trial Balance by the balance method

In this method, the Trial Balance has three columns. The first column is for the head of the account, the second column for writing the debit balance and the third for the credit balance of each account in the ledger

4. Various types of errors

(i) Errors of Commission

Errors caused due to wrong recording of a transaction, wrong posting, wrong totalling, wrong casting, wrong balancing, etc.

(ii) Errors of Omission

Errors caused due to omission of recording a transaction entirely or partly in the books of account.

(iii) Errors of Principle

Errors arising due to wrong classification of receipts and payments between revenue and capital receipts and revenue and capital expenditure.

(iv) Compensating errors

Two or more errors committed in such a way that they nullify the effect of each other on the debits and credits

5. Rectification of errors

Errors affecting only one account can be rectified by giving an explanatory note or by passing a journal entry Errors which affect two or more accounts are rectified by passing a journal entry

6. Meaning and utility of Suspense Account

An account in which the difference in the Trial Balance is put till such time that errors are located and rectified It facilitates the preparation of financial statements even when the Trial Balance does not tally

7. Disposal of Suspense Account

When all the errors are located and rectified, the Suspense Account stands disposed of

TERMS INTRODUCED IN THE CHAPTER

Trial Balance	Errors of principle
Errors of commission	Compensating errors
Errors of omission	Suspense Account

Fill in the Blanks

(1) Errors of principles do not ________ the Trial Balance

(2) The equality of ____________ and ______________ of the Trial Balance does not mean that the individual accounts are also ____________

(3) All ____________ and ____________ accounts appearing in the Trial Balance are transferred to the Trading and Profit and Loss Account.

(4) If the Trial Balance does not ____________ it indicates that some ____________ have been committed

(5) A Suspense Account facilitates the ____________ of financial statements even when the ____________ has not tallied

Multiple Choice Questions

1. Which of the following errors will not affect the Trial Balance?
   (a) Wrong balancing of an account.
   (b) Writing an amount in the wrong account but on the correct side.
   (c) Wrong totalling of an account.
   (d) None of these.

Fill in the Blanks

2. Which of the following errors ~~is an error~~ of omission?
   (a) Sale of Rs. 500 was written in the purchases journal.
   (b) Wages paid to Mohan have been debited to his account.
   (c) The total of the sales journal has not been posted to the Sales Account.
   (d) None of these.
3. Rs. 5,000 paid for the installation of new machinery should be debited to :
   (a) Repairs Account
   (b) Machinery Account
   (c) Expenses Account
   (d) None of these.
4. On purchase of old furniture, Rs. 2,000 spent on its repairs should be debited to ·
   (a) Repairs Account
   (b) Furniture Account
   (c) Wages Account
   (d) None of these
5. Goods worth Rs 400 taken by the proprietor fo personal use should be debited to :
   (a) Debtors Account
   (b) Drawings Account
   (c) Expenses Account
   (d) None of these
6. Purchase of office furniture for Rs 3,400 has been debited to General Expenses Account. It is:
   (a) An error of commission
   (b) An error of omission
   (c) An error of principle
   (d) None of these.
7. Which of the following errors will affect the Trial Balance account?
   (a) Repair to buildings have been debited to buildings.
   (b) The total of purchases journal is Rs. 1,000 short.
   (c) Freight paid on new machinery has been debited to the Freight Account
   (d) None of these.
8. Errors of commission do not allow:
   (a) Correct totalling of the Balance Sheet
   (b) Correct totalling of the Trial Balance.
   (c) The Trial Balance to agree.
   (d) None of these.
9. The preparation of a Trial Balance helps in:
   (a) Locating errors of complete omission.
   (b) Locating errors of principle.
   (c) Locating errors of commission.
   (d) None of these.
10. Which of the following errors is an error of principle.
    (a) Rs. 500 received from Ganpat has been debited to his account.
    (b) Purchase of Rs. 1,000 has been entered in the sales journal.
    (c) Repairs to buildings have been debited to Buildings Account.
    (d) None of these.

Questions

1 Explain the meaning and purpose of the Trial Balance
2. What is a Trial Balance? Name the errors which affect the Trial Balance
3 If a Trial Balance tallies, can it be concluded that there are no errors?
4. Explain errors of omission and give two examples of such errors
5 Explain compensating errors and give two examples of such errors
6 Explain errors of principle and give two examples of such errors
7. Explain errors of commission and give two examples of such errors
8 Explain the limitations of the Trial Balance
9 What are the different types of errors that are usually committed in recording business transactions?
10 Name the errors which do not affect the Trial Balance

EXERCISES

1 Give rectifying journal entries for the following errors.
   (i) A purchase of goods from Rohit amounting to Rs.2,500 has been wrongly passed through the sales book
   (ii) Rs 15,000 paid for furniture purchased has been charged to Purchases Account
   (iii) A cheque for Rs 15,000 received from Ram K Gupta was dishonoured and has been posted to the debit of Sales Returns Account
   (iv) An amount of Rs. 400 due from Mahesh Miglani which has been written off as a bad debt was unexpectedly recovered and has been posted to the personal account of Mahesh Miglani
   (v) Rs. 12,000 paid by cheque for a typewriter was charged to the Office Expense Account.
2. Rectify the following errors
   (i) A sale of furniture of Rs 700 had been credited to Sales Account.
   (ii) Rs. 1,000 paid as rent to the landlord was debited to the Landlord's Account
   (iii) Materials from the store for Rs. 1,000 and wages of Rs. 400 had been used in making tools and implements for use in the factory but no adjustments were made in the books
   (iv) The purchases book was overcast by Rs. 100.
   (v) A sale of Rs. 500 to Gupta & Co. was credited to its account.
3. Rectify the following errors:
   (i) Wages paid for the construction of office was debited to Wages Account, Rs 15,000
   (ii) Cartage paid for the newly purchased furniture, Rs.100 posted to the Cartage Account.
   (iii) Furniture purchased on credit from Ram K. Gupta for Rs 3,000 posted as Rs. 300.
   (iv) Wages paid Rs 2,550, were posted in the Wages Account as Rs. 2,505.
   (v) Purchases from Mamta Rs 1,002, were omitted from the books.
4. The Trial Balance of a book-keeper shows an excess of debits over credits by Rs. 361. This difference is placed in the Suspense Account and the books are closed Later, the following are discovered.

(i) A credit item of Rs 249 has been debited to a personal account as Rs. 429.
(ii) Rs 900 paid for furniture bought has been charged to Purchase Account.
(iii) A discount allowed to a customer has been credited to him as Rs. 145 in place of Rs. 154.
(iv) The total of the returns inward book has been added Rs 10 short.
(v) A cheque for Rs. 100 for miscellaneous expense was not posted to Miscellaneous Expenses Account

You are required to rectify the errors and prepare the Suspense Account

5. Rectify the following errors.
   1. The total of sales book was overcast by Rs. 200.
   2. Rs. 4,000 paid for furniture purchased has been charged to Purchases Account.
   3. Rs. 450 paid to Rasheed was debited to Rushda's Account.
   4. A sum of Rs. 300 paid to Shyam Lal, the clerk, was debited to his personal account.
   5. Rs 150 paid for repairs for the building was debited to the Building Account
6. Rectify the following errors
   1. The total of the purchases book was undercast by Rs. 900
   2. Goods invoiced of the value of Rs. 2,500 and entered in the sales book on December 25 were returned on December 29. Although taken into stock on December 31 no entry was passed in the books.
   3. Discount allowed to Bharat Bhushan of Rs. 150 was not entered in the discount column of the cash book though posted to the credit of his personal account.
   4. A payment of Rs. 1,720 to Ramesh was debited to his account as Rs. 1,270.
   5. A sum of Rs. 320 written off for depreciation on an asset has not been posted to the Depreciation Account.
7. The Trial Balance of New Dealers as on March, 31: 1989, showed a difference, and on scrutiny, the following discrepancies were observed.
   (i) A sales bill for Rs. 8,750 was wrongly debited to the customer's account as Rs. 7,850.
   (ii) Sales to Santosh of Rs. 4,000 was entered in the sales return book but was correctly debited to Santosh.
   (iii) Bill received from Inderjeet Singh of Rs. 5,000 was entered in the bills payable book.
   (iv) An amount of Rs. 6,800 owing by a customer had been omitted from the list of sundry debtors.
   (v) Goods bought from M Masani for an amount of Rs 6,400 has been credited to his account as Rs. 8,400
   (vi) Rs. 987.90 received from Mustaq Ahmed was entered in the cash book as Rs. 990.87.

   Give journal entries rectifying the above errors.
8. Show how you will rectify the following errors:
   (a) Rs. 900 paid for the telephone bill of the telephone at the proprietor's residence was debited to Telephone Expenses Account.
   (b) Cash sales of Rs. 1,200 to Manohar was correctly entered in the cash book but was wrongly posted to Mohan also.
   (c) Rs. 1,500 spent on repairs of a machine was debited to Machinery Account.
   (d) The amount of Rs. 1,200, written off as a bad debt, was recovered and was credited to Ramesh's personal account.

(e) Rs 2,000 included in the wages account was spent on the construction of a cycle shed in the factory.

(f) An amount of Rs 1,200 withdrawn by the proprietor for his personal use has been debited to the Trade Expenses Account

9. Rectify the following errors:

(i) A customer Suresh, returned goods of the value of Rs 700 which was not recorded in the books.

(ii) The debit side of Radhey Lal, a debtor, is overcast by Rs. 7,000.

(iii) A cheque of Rs. 1,400 received from Rajneesh & Sons was dishonoured and debited to Allowances Account.

(iv) A typewriter purchased for the office for Rs. 6,200 was entered in the purchases book.

(v) Purchase of goods from Sushil & Co. for Rs. 3,800 was entered in the sales book as Rs 4,800.

(vi) A credit sale to P Mathur of Rs. 10,000 has been wrongly passed through the purchases book.

(vii) Rs. 250 being the total discount allowed to debtors has been posted to the credit of Discount Received Account.

ANSWERS

Fill in the blanks	*Multiple choice*	
1. affect	1.	(b)
2. debit, credit, accurate	2	(c)
3. revenue, expense	3.	(b)
4. tally, errors	4	(b)
5. preparation, Trial Balance	5.	(b)
	6.	(c)
	7.	(b)
	8.	(c)
	9.	(c)
	10.	(c)

CHAPTER 5

FINANCIAL STATEMENTS

LEARNING OBJECTIVES

After studying this chapter, you should be able to

* explain the meaning, usefulness and types of financial statements;
* understand the meaning, need, and technique of preparing the Trading Account;
* explain the meaning, need, and technique of preparing the Profit and Loss Account;
* understand the meaning, rationale, characteristics, need and preparation of the Balance Sheet.
* differentiate the Trading and Profit and Loss Account and Trial Balance from the Balance Sheet.
* explain the rationale of adjustments and adjusting entries dealing with various types of adjustments required to be made at the time of the preparation of the Final Accounts; and
* understand the presentation of Final Accounts in different forms.

AFTER THE PREPARATION of the Trial Balance, the management of a business enterprise can proceed to prepare financial statements. Such statements are account balances arranged in an effective and meaningful order. The object in doing so is that the financial position of a business establishment is highlighted and the facts presented by them can be readily interpreted and used.

On the basis of information incorporated in these statements·

- —management may review the enterprise's progress to date and decide upon the course of action to be taken in future;
- —creditors may chose to extend, maintain or restrict the flow of credit to a business;
- —shareholders may judge prospects for their investment and elect to sell or continue ownership;
- —employee-groups may form judgements as to the ability of a firm to pay higher wages and bonuses; and
- —the general public may evaluate the effectiveness of the economic entity from which it buys goods and/or services.

The term 'Financial Statements' generally refers to two satatements prepared at the end of an accounting period for an enterprise. These are the Balance Sheet (statement of the financial position) showing the assets and liabilities and capital as on a particular date; and the Trading and Profit and Loss Account (income statement) showing the results of business operations achieved during a certain period. The two statements put together are called Final Accounts in the traditional accounting language.

Beside the two basic financial statements, a Statement of Retained Earnings and a Statement of Changes in the Financial Position (SCFP) are also prepared.

The preparation of Final Accounts has been dealt with in two separate parts to facilitate a proper understanding of their methodology.

(A) Simple Final Accounts.
(B) Final Accounts with Adjustments

(A) SIMPLE FINAL ACCOUNTS

Simple Final Accounts mean the preparation of the Trading and Profit and Loss Account and Balance Sheet without adjustments.

5.1 TRADING ACCOUNT

The first step in the presentation of Final Accounts is the preparation of the Trading Account which is designed to show the gross profit or loss arising or incurred as a result of the trading activities of a business.

5.1.1 Meaning

The Trading Account is an account which shows the result of buying and selling of goods/services. Therefore, it contains, in a summarised form, all the transactions occurring during a trading period which have a direct relation to the goods in which a business deals. It is obvious that the Trading Account does not include any item of operating expenses.

5.1.2 Need

The main purpose of preparing a Trading and Profit and Loss account is two-fold:

(i) to ascertain gross profit and gross loss as a result of buying and selling of goods; and
(ii) to enable management to make a comparison of gross profit or gross loss of the current year with that of previous years.

One of the basic principles of accounting which has already been discussed earlier in this book, postulates the periodic matching of revenues with expenses. **This furnishes the fundamental basis for the preparation of the Trading Account.** However, the elementary Trading

Account is concerned only with the simple profile of the matching exercise and its finer points, represented by necessary adjustments, are dealt with later in this Chapter.

A Trading Account is prepared by debiting this account with the cost of purchases, and expenses directly connected with such purchases, and by crediting the same with the amount of sales.

The following main items appear on the debit side of a Trading Account:

(i) Opening stock
(ii) Purchases less returns
(iii) Wages
(iv) Carriage inwards
(v) Direct expenses like railway freight, custom duties, octroi, etc

The credit side of the Trading Account includes the following items:

(i) Sales less returns
(ii) Closing stock

The difference between the debit and credit side totals of the Trading Account represents either the gross profit or gross loss, as the case may be. The excess of the credit side over the debit side total is termed as Gross Profit. If the debit side total exceeds the credit side, it is called Gross Loss.

The deduction of gross profit from sales would represent the 'Cost of Goods Sold.'

The different items appearing in a Trading Account are explained below:

(i) *Purchases* Goods which have been bought for resale appear as purchases on the debit side of the Trading Account. They include cash as well as credit purchases.

If goods are withdrawn by the proprietor for his personal use, they should be debited to his drawing account, and deducted from purchases.

(ii) *Purchases Returns* Goods which are returned to suppliers are termed as purchases returns or returns outwards. The Purchases Returns Account will have a credit balance. Purchases returns are shown by way of deduction from purchases.

(iii) *Opening Stock* The amount of opening stock appears on the debit side of the Trading Account This is actually the closing stock of the last year and the balance has been brought forward in the current year.

(iv) *Wages* Wages are paid to workers who are engaged in production. In case the manufacturing account is not prepared, they are debited to the Trading Account

(v) *Carriage Inwards/Freight-in* Carriage inwards or freight-in is paid in respect of purchases made during the year It appears on the debit side of the Trading Account In the absence of any other information, carriage/freight is considered to be carriage inwards/freight-in and is debited to the Trading Account.

(vi) *Sales* Sales appear on the credit side of the Trading Account They include credit as well as cash sales.

(vii) *Sales Returns* Goods returned by customers are called returns inwards or sales returns. The Sales Returns Account has a debit balance. These are shown by way of deduction from sales.

(viii) *Closing Stock* The amount of goods unsold at the end of the year is called closing stock. It is shown on the credit side of the Trading Account.

Generally, the closing stock is given outside the Trial Balance. This is so because the closing stock account does not appear in the ledger. Total purchases made during the year are recorded at cost price and debited to the Purchases Account. Total sales made are recorded at selling price and credited to the Sales Account. There is no account kept in the book which will indicate the balance of goods unsold on any given date during the year. Therefore, at the end of the

accounting year, the balance of goods is valued and incorporated in the books by means of the following entry.

Stock
Trading Account

When the above entry is passed, the Closing Stock Account is opened and it appears on the credit side of the Trading Account.

Sometimes, the closing stock appears inside the Trial Balance. This means that the entry to incorporate the closing stock in the books has already been passed

It would imply that the amount of closing stock has been adjusted in the Purchases Account. This would reduce the balance of the Purchases Account which would show the cost price of goods purchased and sold. If the closing stock appears inside the Trial Balance, it will not be shown in the Trading Account.

Closing stock is generally valued at cost price or market price, whichever is less. This practice of valuing the closing stock is based on the accounting concept of realisation. Improper valuation of the closing stock will lead to a misleading figure of gross profit and, consequently, net profit/net loss shown by the Profit and Loss Account will also be untrue

The general proforma of the Trading Account is as follows :

Closing Entries

The preparation of the Trading Account requires that accounts of all items due to appear therein are incorporated by transferring their balances into the Trading Account. The entries required for such transfer are called closing entries.

These are recorded as follows:

1 Opening Stock, Purchases Account, Wages Account, Carriage Inwards and Accounts of Direct Expenses are closed by a transfer to the debit side of the trading account This is done by passing the following entry :

Trading account
Opening Stock
Purchases
Wages
Carriage Inwards
Direct Expenses

2 The Purchases Returns or Returns Outwards Account is closed by transferring its balance to the Purchases Account

The following entry is passed for this purpose —

Purchases Returns
Purchases

3 The Sales Returns or Returns Inwards Account is closed by transferring its balance to the Sales Account as follows:

Sales
Sales Returns

4. The Sales Account is closed by transferring its balance to the credit side of the Trading Account by means of the following entry

Sales
Trading Account

Trading Account

for the year ending

Opening stock ________ Purchases ________ Less Returns _______ Carriage inwards _______ Wages ______ Gross Profit (transferred to P & L A/c)________		Sales______ Less Returns____ ____ Closing stock_______ Gross Loss (Transferred________ to P & L A/c) if any_______	

Closure of Trading Account

The balance of the Trading Account, which is either gross profit or gross loss is transferred to the Profit and Loss Account. For gross profit, the entry is as follows:

Trading Account
    Profit and Loss Account

In the case of gross loss, the entry would be.

Profit and Loss Account
    Trading Account

Example

On December 31, 1988, the following information was available from the books of Raman

	Rs
Stock (1-1-1988)	20,000
Purchases made during the year	1,80,000
Stock (31.12 88)	60,000
Sales	1,90,000
Carriage inwards	5,000
Wages	25,000
Purchase returns	20,000
Sales returns	10,000

Prepare the Trading Account for the year 1988

Solution

Raman

Trading Account for the year ending December 31, 1988

	Rs	Rs.		Rs	Rs
Opening stock		20,000	Sales	1,90,000	
Purchase	1,80,000				
Less returns	20,000	1,60,000	Less returns	10,000	1,80,000
Carriage inwards		5,000	Closing stock		60,000
Wages		25,000			
Gross profit transferred to P & L A/c		30,000			
	Rs	2,40,000		Rs	2,40,000

Manufacturing Account

An enterprise engaged in manufacturing activities will also prepare a Manufacturing Account. It is distinct from the Trading Account. The Manufacturing Account reveals the cost of goods manufactured.

On the debit side of the Manufacturing Account, the following items are shown:

(i) Cost of raw materials consumed :

Opening stock of raw material
Add materials purchased
Less materials returned
Less closing stock of raw materials
Cost of raw material consumed :

(ii) Wages paid to workers engaged in production.

(iii) Factory expenses such as factory rent, rates, power, factory lighting, etc.

(iv) Opening stock of semi-finished goods.

On the credit side of the Manufacturing Account, the following items are shown:

(i) Closing stock of semi-finished goods.

(ii) Sale of scrap.

The Manufacturing Account will have a debit balance. It will show the cost of goods manufactured The Manufacturing Account will be closed by transferring the balance to the debit side of the Trading Account.

Manufacturing and Trading Accounts are different from each other. The Manufacturing Account shows the cost of goods manufactured while the Trading Account is prepared to ascertain the gross profit or gross loss. In the Manufacturing Account, the opening stock and closing stock of finished goods are not shown. The balance of the Manufacturing Account, which is the cost of goods manufactured, is transferred to the Trading Account while the balance of the Trading Account is transferred to the Profit and Loss Account

5.2. PROFIT AND LOSS ACCOUNT

After ascertaining gross profit, management of a business will be interested in knowing the net income earned, or net loss incurred, at the end of the accounting period. With this object in view, a Profit and Loss Account is prepared.

5.2.1 Meaning

The Profit and Loss Account is an account which is designed to highlight the net profit earned or net loss incurred by the business entity arising from its transactions during an accounting period. It contains all the items of revenue gains, losses and operating expenses pertaining to the accounting period

5.2.2 Need

The purpose of preparing the Profit and Loss Account is to ascertain net profit (or net loss) from business operations The net income of the current year can be compared with that of previous years; and deviations in incomes of different periods may be analysed to ascertain the causes of such deviations. Such an analysis will be helpful in controlling expenses that are incurred in running the business enterprise, in selling the goods and in eliminating wastage.

5.2.3 Preparation

The starting point of the Profit and Loss Account is the gross profit/gross loss brought down from the Trading Account The other items shown in this account are those of expenses and losses as well as of incomes and gains. The other items of income or gain such as rent received, commission earned, interest received, etc. are shown on the credit side of the Profit and Loss Account The expenses incurred in the administration of the business and in selling the goods and other revenue losses are shown on the debit side of the Profit and Loss Account.

The excess of the credit side over the debit side is termed as net profit. The excess of the debit side over the credit side is known as net loss Net profit increases owner's equity whereas net loss decreases it.

Some of the items appearing in the Profit and Loss Account are explained below.

(i) *Salaries* Salaries paid to employees are debited to the Profit and Loss Account The item "salaries and wages" is treated as salaries and is debited to the Profit and Loss Account. On the other hand, the item "wages and salaries" is treated as wages and is debited to the Trading account

(ii) *Rent* The amount of rent paid is shown on the debit side of the profit and Loss Account It should be distinguised from the rent received. The amount of rent received is an item of income and it will appear on the credit side of the Profit and Loss Account

(iii) *Discount* Discount is of two types:

(a) Trade discount

(b) Cash discount.

(a) *Trade Discount* It is given on bulk purchases and bulk sales. It is deducted from the amount of purchases and sales before they are recorded in the books There is no further treatment of trade discount. Consequently, it will not appear in the Trial Balance.

(b) *Cash Discount* Cash discount is given to encourage prompt payments. When discount is received from creditors, it is an income and is shown on the credit side of the Profit and Loss Account, when discount is allowed to customers, it is regarded as an expense and is debited to the Profit and Loss Account.

(iv) *Bad Debts* A debt which becomes irrecoverable is known as a bad debt This is an item of loss for the business and appears on the debit side of the Profit and Loss Account.

(v) *Carriage Outwards or Freight Outwards* This is the amount paid by way of transportation charges in respect of goods sold. It is debited to the Profit and Loss Account

(vi) *Drawings* Drawings represent the sums of money or goods withdrawn by the proprietor from the business for personal use This is debited to his Capital Account (This item relates to the Balance Sheet.)

(vii) *Income-tax* The treatment of income-tax will depend upon whether we are preparing the Final Accounts of sole trader/partnership firm or joint stock companies. In the former case, income-tax will be deducted from the capital and will not be debited to the Profit and Loss Account; whereas in the case of joint stock companies, it is debited to the Profit and Loss Account in the form of a provision.

(viii) *Loss by fire, theft, etc* Such losses are regarded as abnormal losses and are debited to the Profit and Loss Account

(ix) *Loss or gain on sale of fixed assets* Sometimes, a business enterprise may sell the fixed assets such as furniture, machinery, building, etc in the course of business operations and may incur a loss or make a profit on its sale Loss on the sale of a fixed asset is treated as a revenue loss and is debited to the Profit and Loss Account, profit on the sale of a fixed asset is transferred to the credit side of the Profit and Loss Account as a revenue gain.

The general proforma of the Profit and Loss Account is given below:

Profit and Loss Account for the Year ending

	Rs.		Rs
Gross loss (if any)		Gross profit	
Rent, rates and taxes		Interest received	
Office salaries		Discount received	
Printing and stationery		Rent received	
Postage		Commission received	
Bank charges		Income from investment	
Telephone charges		Profit on sale of fixed assets	
Legal charges		Net loss if any (transferred to the capital account)	
Audit fees			
Advertising			
Commission			
Bad debts			
Packing charges			
Carriage outwards			
Insurance			
Depreciation			
Repairs and maintenance			
Interest on loan			
Discount allowed			
Loss by fire			
Loss on sale of fixed assets			
Interest on capital			
Net profit (transferred to the Capital Account)			

Closing Entries

The preparation of the Profit and Loss Account requires that the balances of accounts of all concerned items are transferred to it for its compilation. The following closing entries are passed to give effect to such transfer of balances:-

(i) Accounts of various items of expenses and losses are transferred to the debit side of the Profit and Loss Account The entry is as follows·

Profit and Loss Account
Each item of expense or loss

The entry will close all the accounts of items of expenses or losses.

(ii) Balances of the accounts of items of income and gain will be transferred to the credit side of the Profit and Loss Account by means of following entry ·

Each item of income and gain
Profit and Loss Account

This entry will close the accounts of different items of income and gain

Closure of Profit and Loss Account

The balance of the Profit and Loss Account will be either a debt balance or a credit balance In either case, it will be transferred to the Capital Account of the proprietor or partners.

The debit balance of the Profit and Loss Account, known as net loss, will be transferred to the debit side of the Capital Account The entry will be.

Capital
Profit and Loss Account

The credit balance of Profit and Loss Account, known as net profit, will be transferred to the credit side of the Capital Account The entry is as follows:

Profit and Loss Account
Capital

Closure of Drawings Account

Drawings of the proprietor/partner will be transferred to his Capital Account by means of the following entry

Capital
Drawing

This will close the Drawings Account This item relates to the Balance Sheet

Example

From the following information, prepare a Profit and Loss Account for the year ending December 31, 1988.

	Rs.
Gross Profit	60,000
Rent	5,000
Salary	15,000
Commission paid	7,000
Interest on loan	5,000
Advertising	4,000
Discount received	3,000
Printing and stationery	2,000
Legal charges	5,000
Bad debts	1,000
Depreciation	2,000
Interest received	4,000
Loss by fire	3,000

Profit and Loss Account for the year ending December 31, 1988

	Rs		Rs
Rent	5,000	Gross profit	60,000
Salary	15,000	Discount received	3,000
Commission	7,000	Interest received	4,000
Interest on loan	5,000		
Advertising	4,000		
Printing & Stationery	2,000		
Legal charges	5,000		
Bad debts	1,000		
Depreciation	2,000		
Loss by fire	3,000		
Net profit (transferred to the Capital Account)	18,000		
Rs	67,000	Rs	67,000

5.3 BALANCE SHEET

Management of a business would like to know the financial position of an enterprise at a certain date, over and above getting information about the realisation of the economic goals of the business entity. A Balance Sheet is a statement which is prepared and presented for this purpose

5.3.1 Meaning

A Balance Sheet is a statement of assets and liabilities of a business enterprise at a given date It is prepared at the end of the accounting period after the Trading Account and Profit and Loss Account have been prepared. It shows the financial position of the business at the close of the accounting period. It is called a Balance Sheet because it is a sheet of balances of ledger accounts which are still open after the preparation of the Trading and Profit and Loss Account.

Rationale

The Balance Sheet is prepared on a particular date and, therefore, the information contained in it is valid only for that date In a Balance Sheet, the total of all assets must be equal to the total of all liabilities and capital at a given date ·

Total assets = Capital + Liabilities or

Capital = Total assets — liabilities

Characteristics

(i) A Balance Sheet is a part of the Final Accounts It is not an account. It is only a statement of assets and liabilities It has no debit side or credit side. The headings of the two sides are assets and liabilities

(ii) A Balance Sheet is prepared on a particular date It shows the assets and liabilities of an enterprise on that date Even a single transaction would cause a change in the assets and liabilities of a business Hence, a Balance Sheet is true only for the date on which it is prepared.

(iii) A Balance Sheet is a summary of balances of accounts which have not been closed by transfer to the Trading and Profit and Loss

Account Its agreement is proof of the arithmetical accuracy of the adjustments which are made while preparing the Final Accounts

(iv) A Balance Sheet shows the nature and cost of assets and the nature and the amount of liabilities at a given date.

5.3.2 Need

The purpose of preparing a Balance Sheet are as follows·

(i) To ascertain the nature and cost of assets of a business

(ii) To determine the nature and amount of liabilities of a business.

(iii) To find out the solvency of a business enterprise. A business is solvent if the assets exceed the external liabilities.

5.3.3 Preparation

All the permanent accounts, i.e. accounts of assets, liabilities and owner's equity are shown in the Balance Sheet In fact, all those accounts which have not been closed till the preparation of the Trading and Profit and Loss Account are shown either on the assets side or liabilities side of Balance Sheet, depending upon their nature

Accounts of capital and liabilities are shown on the left hand side, known as 'Liabilities' Assets and other debit balances are shown on the right hand side, known as 'Assets'

Items which are generally included in a Balance Sheet are explained below.

(1) *Current Assets* Current assets are those which are either in the form of cash or can be converted into cash within a year.

(a) *Cash at Bank* It represents the balance of cash in the account of the enterprise with a bank.

(b) *Bills Receivable* Bills of exchange received from customers are termed as 'bills receivable'. Bills receivable shown under this heading are those bills of exchange which have not yet matured for payment and which have not been discounted or endorsed to third parties.

(c) *Sundry Debtors* This represents the sum total of debit balances appearing in the customers' accounts.

(d) *Prepaid Expense* Prepaid expense is that which has been paid in advance for services to be received in the future It is shown as an asset in the Balance Sheet.

(e) *Accrued Income* Accrued income is that which has been earned but has not yet been received or has not become due

(f) *Closing Stock* Closing stock has been explained earlier in the chapter

(2) *Current Liabilities* Current liabilities are those liabilities which are expected to be paid within a year and which are usually to be paid out of current assets

(a) *Bank Overdraft* When an undertaking withdraws from the bank more than the amount deposited in its account, it is known as an overdraft.

(b) *Outstanding Expenses* Those expenses which have become due for payment but have not yet been paid are known as outstanding expenses.

(c) *Bills Payable* Bills of exchange accepted in favour of creditors are known as bills payable They represent the amount of bills which have not yet become due for payment.

(d) *Sundry Creditors* This represents the sum total of credit balances appearing in the accounts of creditors

(3) *Fixed Assets* Fixed assets are those assets which are held on a long-term basis in the business

(4) *Investments* Investments represent the funds invested in Government securities, shares

of a company, etc They are shown at cost price. If, on the date of preparation the Balance Sheet, the market price of investments is lower than the cost price, a foot note to that effect may be appended to the Balance Sheet.

(5) *Long-term Liabilities* Those liabilities which mature for payment after a period of one year are known as long-term liabilities.

(6) *Capital* It is the excess of assets over liabilities due to outsiders It represents the amount originally contributed by the proprietor/partners which is increased by profits and decreased by losses and drawings.

(7) *Drawings* Drawings by the proprietor has the effect of reducing the balance on his Capital Account Therefore, the Drawings Account is closed by transferring its balance to his Capital Account. However, it is shown by way of deduction from capital in the Balance Sheet.

Grouping and Marshalling of Assets and Liabilities

The items appearing in the Balance Sheet are properly grouped and presented in a particular order. The term 'grouping' means putting together items of a similar nature under a common heading. For example, under the heading 'Sundry Debtors', the balance of accounts of all the customers to whom goods have been sold on credit will be shown

'Marshalling' denotes the order in which assets and liabilities are shown in the Balance Sheet Assets and liabilities can be marshalled in two ways:

(i) Assets can be shown in order of liquidity Order of liquidity means the order in which they can be converted into cash. The most liquid asset, i e., cash in hand, is shown first The least liquid asset, i e , goodwill, is shown last

The liabilities of a business are arranged in order of urgency of payment The one which is most urgent to be paid, i.e, short-term creditors, is shown first; the least urgent to be paid is, i e, long-term creditors, is shown last

(ii) Assets and liabilities can be shown in the order of permanence. Permanent assets and liabilities are shown first, followed by current asset and liabilities This method is exactly the reverse of the first method given above Business enterprises on the lines of sole-proprietorship and partnership follow the first method to marshall their Balance Sheets Joint stock companies prepare their balance sheets in order of permanence

PROFORMA OF A BALANCE SHEET

A In Order of liquidity

Balance Sheet as on ——————

Liabilities	Rs.	*Assets*	
Current liabilities		*Current Assets*	
Bank overdraft		Cash in hand	
Bills payable		Cash at bank	
Outstanding Expenses		Bills receivable	
Sundry creditors		Sundry debtors	
Income received in advance		Prepaid Expenses	
		Accrued income	
		Closing stock	
Longterm liabilities		*Investments*	
Loan		*Fixed Assets*	
Capital			
Opening balance		Furniture and fixtures	
Add net profit		Plant and machinery	
(less net loss) ——		Building	
Less drawings ——		Land	
		Goodwill	
Rs		Rs	

B In order of permanence

Balance Sheet as on ——————

Liabilities	Rs	*Assets*	
Capital		*Fixed Assets*	
Opening Balance		Goodwill	
Add net profit		Land	
(less net loss)		Building	
Less drawing		Plant and machinery	
		Furniture and fixtures	
Long term liabilities		*Investments*	
		Current Assets	
Loan		Closing stock	
Current Liabilities		Accrued income	
Income received in advance		Prepaid expenses	
Sundry creditors		Sundry debtors	
Outstanding expenses		Bills receivable	
Bills payable		Cash at bank	
Bank overdraft		Cash in hand	
Rs		Rs	

Valuation of Assets

The accuracy of a Balance Sheet depends, to a great extent, upon the valuation of assets. It is, therefore, necessary that valuation of assets is done in accordance with the generally accepted accounting principles A Balance Sheet is prepared to show the financial position of the business as a going concern. It does not show the realisable values of the assets Fixed assets are usually valued at cost less estimated depreciation.

Current assets are usually valued at cost or market price, whichever is less. The basic principle underlying the valuation of current assets is that anticipated losses are taken into account but expected profits are not considered

Difference between Trading and Profit and Loss Account and Balance Sheet

The basic difference between the Trading and Profit and Loss Account and the Balance Sheet lies in their need for preparation, structure and form. The Trading and Profit and Loss Account is prepared to ascertain the results of business operations during a given period whereas the Balance Sheet is prepared to know the financial position of the business at a particular date

Revenue and expense items are shown in the Trading and Profit and Loss Account while in the Balance Sheet, only those accounts appear, which remain open after the preparation of the Trading and Profit and Loss Account The Trading and Profit and Loss Account and Balance Sheet are part of the Final Accounts. The Trading and Profit and Loss Account is a ledger account; it has debit side and a credit side and its balance is transferred to the Capital Account The Balance Sheet is only a statement of assets and liabilities, it has no debit side or credit side. Its agreement is proof of the arithmetical accuracy of the adjustments carried out for the purpose of preparing the Trading and Profit and Loss Account.

Difference between Trial Balance and Balance Sheet

The following are the main points of difference between Trial Balance and the Balance Sheet

Trial Balance	*Balance Sheet*
1 A Trial Balance is prepared to check the arithmetical accuracy of posting of transactions to the ledger	1. A Balance Sheet is prepared to know the financial position of the business enterprise on a given date
2. A Trial Balance can be prepared frequently It may be prepared at the end of a month or a quarter.	2. A Balance Sheet is generally prepared at the end of the accounting period.
3. The headings of the two columns are 'debit balances' and 'credit balances'.	3. The headings of the two sides are "Liabilities" and "Assets".
4. All types of accounts find their place in the Trial Balance.	4. In a Balance Sheet, accounts of assets, liabilities, capital and those accounts which have remained open on the date of the Balance Sheet are presented.

5. Generally, the opening stock appears in the Trial Balance, whereas the closing stock does not	5. In a Balance Sheet, only the closing stock appears on the assets side
6. In a Trial Balance, it is not possible to have information about net profit or net loss.	6 In the Balance Sheet, information about net profit earned or net loss incurred is provided.
7. A Trial Balance can be prepared without making adjustments regarding prepaid expenses, incomes received in advance, accrued income, etc.	7. A Balance Sheet cannot be prepared without making adjustments regarding prepaid expenses, outstanding expenses, income received in advance or accrued income, making provisions for possible losses, etc.
8. It is desirable to prepare a Trial Balance, though its preparation can be dispensed with.	8 It is essential to prepare a Balance Sheet at the end of the accounting period.

Example

From the following information prepare a balance sheet of Mr X as on December 31, 1988.

Cash in hand	4,400
Cash in bank	10,000
Capital	1,63,000
Machinery	60,000
Furniture & fittings	12,600
Sundry debtors	85,000
Sundry creditors	30,000
Stock	27,000
Bills payable	7,000
Prepaid expenses	1,000

Balance Sheet as on December 31, 1988

Liabilities	*Rs*	*Assets*	*Rs*
Bills payable	7,000	Cash in hand	4,400
Sundry creditors	30,000	Cash at bank	10,000
Capital	1,63,000	Sundry debtors	85,000
		Prepaid expenses	1,000
		Stock	27,000
		Furniture & fittings	12,600
		Machinery	60,000
Rs.	2,00,000	Rs.	2,00,000

Demonstration Problems

Problem 1

The following is the Trial Balance of Mohan Ram as on December, 31 1988.

Debit balance	*Rs*	*Credit balance*	*Rs*
Stock (1 1.88)	3,000	Sale	52,000
Purchases	37,000	Purchases returns	900
Carriage	300	Creditors	11,000
Sales returns	500	Capital	9,000
Salary	4,000	Bills payable	5,000
Wages	1,000		
Rent	1,800		
Discount	1,000		
Repairs	300		
Misc Exp	1,000		
Cash in hand	3,000		
Furniture & fixtures	6,000		
Debtors	12,000		
Drawings	7,000		
Rs	77,900	Rs	77,900

His closing stock on December 31, 1988 was Rs 8,000.

You are required to pass the closing entries and prepare the Trading and Profit and Loss Account for the year ending December 31, 1988 and a Balance Sheet as on that date.

Solution

	Rs	Rs
Trading Account	41,800	
Stock		3,000
Purchases		37,000
Carriage		300
Wages		1,000
Sales returns		500
(Transfer of balances to Trading Account).		
Sales	52,000	
Purchases returns	900	
Trading Account		52,900
(Transfer of Sales and Purchases returns to Trading Account)		
Closing stock	8,000	
Trading Account		8,000
(Value of stock on hand at the end of the year brought into account)		

	Rs	Rs
Trading account	19,100	
Profit and Loss Account		19,100
(Transfer of gross profit to Profit and Loss account)		
Profit and Loss Account	8,100	
Salary		4,000
Rent		1,800
Discount		1,000
Repairs		300
Misc.Exp.		1,000
(Transfer of balances to Profit and Loss Account)		
Profit and Loss Account	11,000	
Capital		11,000
(Transfer of net profit to capital)		
Capital	7,000	
Drawing		7,000
(Transfer of drawings to capital)		

Trading and Profit and Loss Account
for the year ending December 31, 1988

		Rs			Rs
Opening stock		3,000	Sales	52,000	
Purchases	37,000		Less returns	500	51,500
Less returns	900	36,100			
Carriage		300	Closing stock		8,000
Wages		1,000			
Gross profit c/d		19,100			
	Rs	59,500		Rs	
59,500					
Salary		4,000	Gross profit b/d		19,100
Rent		1,800			
Discount		1,000			
Repairs		300			
Misc.Exp		1,000			
Net profit (transferred to capital account)		11,000			
	Rs	19,100		Rs	19,100

Mohan Ram
Balance Sheet as on December 31, 1988

Liabilities		Rs	*Assets*	Rs
Bills payable		5,000	Cash in hand	3,000
Sundry creditors		11,000	Debtors	12,000
Capital	9,000		Closing stock	8,000
Add net Profit	11,000		Furniture & fixtures	6,000
	20,000			
Less drawings	7,000	13,000		
	Rs	29,000	Rs	29,000

Problem 2

The following balances were extracted from the books of Avtar Singh on March 31, 1988·

	Rs
Capital	73,000
Drawings	12,000
Gen. expenses	4,000
Buildings	30,000
Mechinery	15,000
Stock (April 1, 1987)	20,000
Power	3,000
Taxes and insurance	2,700
Wages	10,000
Debtors	25,000
Creditors	20,000
Bad debts	1,900
Sales	80,000
Purchases	50,000
Scooter	8,000
Commission received	2,000
Bills payable	5,000
Cash in hand	4,000
Bank overdraft	6,000
Packing expenses	400

Stock on hand on March 31, 1988, was of the value of Rs. 30,000

You are required to prepare the Trading and Profit and Loss Account for the year ending March 31, 1988, and also the Balance Sheet as on that date.

Solution

Trading and Profit & Loss Account

for the year ending March 31, 1988

	Rs		Rs
Opening stock	20,000	Sales	80,000
Purchase	50,000	Closing stock	30,000
Wages	10,000		
Power	3,000		
Gross profit c/d	27,000		
Rs.	1,10,000	Rs	1,10,000
General expenses	4,000	Gross profit b/d	27,000
Taxes & Insurance	2,700	Commission received	2,000
Bad debts	1,900		
Packing expenses	400		
Net profit (Transferred to the capital account)	20,000		
Rs.	29,000	Rs.	29,000

Avtar Singh
Balance Sheet as on March 31, 1988

Liabilities		Rs	*Assets*	Rs
Bank overdraft		6,000	Cash in hand	4,000
Bills payable		5,000	Debtors	25,000
Creditors		20,000	Stock	30,000
Capital	73,000		Scooter	8,000
Add Net profit	20,000		Machinery	15,000
	93,000			
Less Drawing	12,000	81,000	Building	30,000
		1,12,000		1,12,000

Problem 3

The following are the balances as on December 31, 1988, extracted from the books of Hamic Ali.

	Rs
Bills payable	4,000
Oustanding expenses	1,000
Sales	1,00,000
Purchases	70,000
Returns inward	1,500
Returns outward	2,300
Stock	18,000
Carriage	3,000
Rent & rates	4,500
Discount allowed	2,000
Discount received	1,000
Printing	1,500
Insurance	2,200
Postage & telegrams	400
Miscellaneous expenses	700
Bad debts	1,000
Debtors	30,000
Creditors	33,000
Wages	8,000
Drawings	4,000
Capital	60,000
Building	45,000
Furniture	2,500
Cash in hand	7,000

The stock on December 31, 1988, was Rs. 25,000.

You are required to prepare the Trial Balance, Trading Account and Profit and Loss Account for the year ending December 31, 1988, and also the Balance Sheet as on that date

Solution

Hamid Ali
Trial Balance as on December 31, 1988

Particulars	*Debit Balances*	*Credit Balances*
	Rs	Rs
Bills payble		4,000
Outstanding expenses		1,000
Sales		1,00,000
Purchases	70,000	
Returns inward	1,500	
Returns outward		2,300
Stock	18,000	
Carriage	3,000	
Rent & rates	4,500	
Discount allowed	2,000	
Discount received		1,000
Printing	1,500	
Insurance	2,200	
Postage & telegrams	400	
Miscellaneous expenses	700	
Bad debts	1,000	
Debtors	30,000	
Creditors		33,000
Wages	8,000	
Drawings	4,000	
Capital		60,000
Building	45,000	
Furniture	2,500	
Cash in hand	7,000	
Rs	2,01,300	2,01,300

Trading and Profit and Loss Account

for the year ending December 31, 1988

		Rs			Rs
Opening stock		18,000	Sale	1,00,000	
Purchase	70,000		Less returns inwards	1,500	98,500
Less Returns outward	2,300	67,700	Stock		25,000
Carriage		3,000			
Wages		8,000			
Gross profit c/d		26,800			
	Rs	1,23,500		Rs	1,23,500
Rent & rates		4,500	Gross profit b/d		26,800
Discount		2,000	Discount received		1,000
Printing		1,500			
Insurance		2,200			
Postage & telegrams		400			
Miscellaneous Expenses		700			
Bad debts		1,000			
Net Profit (transferred to the Capital Account)		15,500			
	Rs	27,800		Rs	27,800

Hamid Ali

Balance Sheet as on December 31, 1988

Liabilities			*Assets*	
		Rs		Rs
Outstanding expenses		1,000	Cash in hand	7,000
Bills payable		4,000	Debtors	30,000
Creditors		33,000	Stock	25,000
Capital	60,000		Furniture	2,500
Add Net profit	15,500		Building	45,000
	75,500			
Less drawings	4,000	71,500		
	Rs.	1,09,500	Rs	1,09,500

(B) Final Account with Adjustments

The preparation of simple final accounts presupposes the absence of any accounting complexities, which are a normal feature of business operations. These accounting complexities arise due to the fact that the process of determining income and financial position is founded on the accrual basis of accounting. This requires that certain adjustments are incorporated in simple Final Accounts

Rationale of Adjustments—

Accrual Basis

According to accrual accounting, the impact of events of assets and liabilities is recognised in the time periods when services are rendered or utilised, instead of when cash is paid or received. Revenue is recognised as it is earned and expenses are recognised as they are incurred This has nothing to do with the cash changing hands between the parties

Another important consideration in the preparation of Final Accounts with adjustments is the vital distinction between capital and revenue. Items of revenue income, revenue expenditure and revenue losses are shown in the Trading and Profit and Loss Account Capital expenditure, capital losses, capital income and capital receipts are excluded from this account.

The general guideline for the preparation of Trading and Profit and Loss Account on accrual basis is that revenue income and revenue expenditure for the current period only are included in this account. This guideline, as applied in practice, may be spelt out as thus :

(1) Any expenditure which pertains to the future, though already incurred, is excluded.
(2) An expense, which has already been incurred but has not yet been paid, will be included
(3) Income or receipts, which pertain to the current period whether received in cash or not, are included
(4) Income or receipts, which have been received in advance in cash but pertain to the next accounting period, are excluded

5.4 CLASSIFICATION OF CAPITAL AND REVENUE

5.4.1 Capital Expenditure

Capital expenditure is that expenditure which results in the acquisition of assets held on a long-term basis Further, any expenditure which adds to the productivity or earning capacity of the assets is regarded as capital expenditure The cost of land, building, plant and machinery, office furniture etc is treated as capital expenditure It normally yields benefits over a long period and is shown in the Balance Sheet

5.4.2 Revenue Expenditure

Expenditure which is incurred in the administration of the business or in making sales is termed as revenue expenditure. Examples of revenue expenditure are rent, advertising, bank charges, salaries, lighting, legal expenses, etc.

Further, all expenses incurred on repairs and maintenance of assets, cost of goods bought for resale, interest paid on loans, loss on sale of assets, are treated as revenue expenditure or revenue loss

Revenue expenditure yields benefits during the current year and is shown in the Trading and Profit and Loss Account

5.4.3 Deferred Revenue Expenditure

Deferred revenue expenditure is one which shows the characteristics of both capital and revenue expenditure It adds to the profit potential of business operations but its effect wears out over a relatively short period as compared with the effect of capital expenditure.

Usually, the benefits of such an expenditure lasts between 3 to 7 years. Examples are advertisements, development expenditure, expenditure on research and development, etc.

5.4.4 Capital Receipts

Owner's contribution as capital, amount received by way of loan, sale proceeds of fixed assets, etc are regarded as capital receipts. However, loss or profit on the realisation of fixed assets is treated as a revenue item and may be debited or credited to the Profit and Loss Account as the case may be. Capital receipts are excluded from the Trading and Profit and Loss Account

5.4.5 Revenue Receipts

Income earned in the course of business is treated as revenue receipt Sale of goods, interest earned, rent received, commission received, etc. are regarded as revenue receipts Sale proceeds of old newspapers, packing materials and sundry receipts are also treated as revenue receipts.

5.5 ADJUSTMENTS IN FINAL ACCOUNTS

The adjustments that are usually necessary, in the light of accrual basis of accounting, at the end of the accounting period for the preparation of the Trading and Profit and Loss Account are generally as follows :

1. Outstanding expenses
2. Prepaid expenses
3. Income earned but not received
4. Income received in advance
5. Depreciation
6. Provision for bad and doubtful debts
7. Provision for discount on debtors
8. Provision for discount on creditors
9. Interest on capital
10. Interest on drawings
11. Commission on profit.

Entries which are passed to incorporate these adjustments into Final Accounts are called *'adjusting entries'*

5.5.1 Outstanding Expenses

It is quite common for a business enterprise to be left with some unpaid expenses in the normal course of business operations at the end of the accounting year due to one reason or the other. Such expenses are called outstanding expenses

As these expenses have been incurred in the earning of revenue during the accounting year, it is logical that they should be duly charged against revenue for computation of net income

The entry to bring such expenses into account is

Expense
  Outstanding Expense

The above entry results in a credit balance on a new account called 'Outstanding Expenses' which is placed on the liabilities side of the Balance Sheet.

The amount of outstanding expenses is added to the total of expenses under a particular head for the purpose of preparation of the Trading and Profit and Loss Account

Whenever outstanding expenses at the end of the year are paid during the succeeding accounting year, the entry to record the payment is as follows :

Outstanding expenses
  Bank/Cash

The effect of the above entry is that the Outstanding Expenses Account is closed by the payment made in cash

Example

B has paid rent of 11 months (from January to November) @ Rs 1000 p m. For the month of December, it is still to be paid. The accounting

year closes on December 31. Pass the adjusting entry and show how it would appear in the Profit and Loss Account and Balance Sheet.

Solution

Since the accounting year closes on December 31, the rent is outstanding for one month.

The necessary entry for the adjustment of outstanding rent is :

Rent	1,000	
Outstanding Rent		1,000

It will be shown in the Profit and Loss Account and Balance Sheet as follows :

Profit & Loss Account

Dr. Cr

		Rs	
Rent	11,000		
Add Outstanding Rent	1,000	12,000	

Balance Sheet

Liabilities	Rs	
Outstanding Rent	1,000	

5.5.2 Prepaid Expenses

There are several items of expenses which are paid in advance in the normal course of business operations. The examples of such expenses paid in advance are insurance premium, rent, etc. At the end of the accounting year, it is found that the benefits of such expenses have not been fully received; a portion of the total benefits would be received in the next accounting year. That portion of the expense, the benefit of which will be received during the next accounting year, is known as 'Prepaid Expenses'

The necessary adjustment in respect of prepaid expenses is made by passing the following entry

Prepaid Expense
Expense

The effect of the above adjusting entry is that a 'Prepaid Expense' account is opened and the amount of prepaid expense is deducted from the total of the particular expense.

It will be shown in the Profit and Loss account and Balance Sheet in the following manner ·

Profit and Loss Account

Dr Cr.

Expense	———		
Less Prepaid Expense	———	———	

Balance Sheet

	Assets	
	Prepaid expense	———

Next year the prepaid expense account will be closed by transferring its balance to the relevant expense account The following entry will be passed for this purpose

Expense
Prepaid expense

5.5.3 Income Earned but not Received (Accrued Income)

It may also happen that certain items of income such as interest on loan, commission, rent, etc., are earned during the current accounting year but have not been actually received by the end of the same year. Such incomes are known as 'Accrued Income'

The adjusting entry for accrued income is

Accrued come
Income

The income account will be transferred to the Profit and Loss Account and 'Accrued Income Account' will appear on the asset side of the Balance Sheet.

At the commencement of the next year, the Accrued Income Account will be closed by transferring its balance to the Income Account. The entry will be ·

Income	
Accrued income	

Example

A's trial balance as on December 31, 1988, contains the following information :

	Dr.	Cr.
Investments		
(rate of interest 12% p.a.)	10,000	
Interest received		1,000

Pass the adjusting entry and show how it would appear in the Profit and Loss Account and Balance Sheet.

Solution

In this case, interest for two months has not been received: For this, the necessary entry is :

Accrued interest	200	
Interest		200

It will appear in the Profit and Loss Account and Balance Sheet as follows:

Dr. Profit & Loss Account Cr

	Interest received	1000	
	Add Accrued interest	200	1200

Balance Sheet

	Assets	Rs.
	Accrued interest	200

5.5.4 Income Received in Advance

Sometimes, a certain income is received but the whole amount of it does not belong to the current accounting period, a part of it belongs to the next period. Such portion of the income which belongs to the next accounting period is income received in advance and is known as 'Unearned Income,' e.g. rent received in advance.

Income received in advance is adjusted by passing the following entry:

Income	
Income received in advance	

The effect of this entry will be that the balance in the Income Account will be equal to the amount of income earned for the current accounting period.

'Income Received in Advance Account' will be shown as a liability in the Balance Sheet. In the next accounting year, the 'Income Received in Advance Account' is closed by transferring its balance to the appropriate income account. The follwing entry will be passed for this purpose:

Income received in advance	
Income	

After making the adjustment entries for outstanding expenses, prepaid expenses, accrued income, incomes received in advance, all the accounts concerned are closed by passing closing entries which have been discussed earlier in the the Chapter.

5.5.5 Depreciation

Depreciation is the decline in the value of an asset on account of wear and tear or passage of time or both. It is a business expense though it is not paid in cash every year. It appears on the debit side of the Profit and Loss Account. When depreciation of an asset is debited to the Profit and Loss Account, it actually amounts to writing off a portion of the cost of an asset which has been used in the business for the purpose of earning profits.

The entry for providing depreciation is :

Depreciation	
Concerned asset	

In the Balance Sheet, the asset will be shown at cost minus the amount of depreciation.

5.5.6 Provision for Bad and Doubtful Debts

It is a normal feature of business operations that some debts prove irrecoverable which means that the amount to be realised from them becomes bad.

Depending upon the course of business transactions in successive accounting periods, the amount of bad debts incurred by the business may change from year to year, thereby affecting profits one way or the other

In view of this, an attempt is made to bring in a certain element of certainty in the amount in respect of bad debts charged every year against income.

This attempt takes the form of maintaining a provision designed to cover the loss of bad debts by means of a predetermined percentage of net debts (debts less provision) every year at the time of the preparation of the Final Accounts This provision is known as provision for 'Bad and Doubtful Debts.'

When bad debts are incurred in the succeeding accounting year, they are charged to the Provision for Bad and Doubtful Debts Account Consequently, the balance on the provision for Bad and Doubtful Debts Account is reduced. At the end of the next accounting year, a fresh provision is made again on the amount of net debtors at a predetermined percentage in order to increase the balance on the provision account to the required level.

Thus, the fresh amount to be calculated regarding the Provision for Bad and Doubtful Debt Account and to be debited to the Profit and Loss Account at the end of the succeeding accounting year is calculated as thus:

Bad debts	—	
Add new provision	—	
Less old provision	—	—

In the context of this basic outline of the operation of the Provision for Bad and Doubtful Debts Account, the acounting treatment would be as follows:

(1) Initial creation of provision at the end of the year

Profit and Loss
Provision for Bad and Doubtful Debts
(Amount credited to Provision Account)

(2) Bad debts incurred (succeeding year)

Bad debts
Sundry debtors
(Amount of bad debts recorded)

(3) Closure of Bad Debts Account (succeeding year)

Provision for Bad and Doubtful Debts
Bad debts
(Transfer of bad debts to the Provision Account)

This accounting treatment is repeated at the end of every year

Example

B's trial balance provides the following information

Debtors	50,000
Bad debts	2,000

It is desired to create a provision of 5% on debtors at the end of the year. Pass necessary entries and show it in the Final Accounts

Solution

Bad debts appear in the Trial Balance Therefore, they have already been adjusted Provision for bad and doubtful debts does not appear in the Trial Balance.

Bad debts will be transferred to the Profit and Loss Account The entry will be·

Profit and Loss Account	2,000	
Bad debts		2,000
(Transfer of bad debts to P & L Account)		

Provision for bad and doubtful debts will be created by passing the following entry:

Profit and Loss Account	2,500	
Provision for bad and doubtful debts		2,500
(Provision for bad and doubtful debts created)		

The above adjustments will appear in the Profit and Loss Account and Balance Sheet as follows:

Dr. Profit and Loss Account Cr

Bad debts	2,000	
Provision for bad and doubtful debts	2,500	

Balance Sheet

	Assets		
	Debtors	50,000	
	Less Provision	2,500	47,500

Example

B's trial balance provides the following information :

	Debit	Credit
Debtors	30,000	
Bad debts	1,200	
Provision for bad and doubtful debts		1,300

It is desired to make a provision for bad and doubtful debts at 5% on debtors at the end of the year.

Pass necessary entries and show how the adjustments will appear in the Final Accounts.

Solution

The Bad Debts Accounts will be transferred to the Provision for Bad and Doubtful Debts Account and thus closed. The entry will be:

Provision for bad and doubtful debts	1,200	
Bad debts		1,200
(Transfer of bad debts to provision for bad and doubtful debts)		

The following entry will be passed to create a provision of 5% on debtors at the end of the year

Profit and Loss Account	1,400	
Provision for bad and doubtful debts		1,400
(Provision for bad and doubtful debts created)		

Dr. Profit and Loss Account Cr.

Bad debts	1,200		
Add New provision	1,500		
	2,700		
Less Old provision	1,300		1,400

Balance Sheet

	Assets		
	Debtors	30,000	
	Less Provision	1,500	28,500

Dr Provision for Bad and Doubtful Debts Account Cr

Bad debts	1,200	Balance b/d	1,300
Balance c/d	1,500	Profit and Loss Account	1,400
	2,700		2,700
		Balance b/d	1,500

However, for the sake of proper understanding of the treatment for the provision for bad and doubtful debts, its application under the following conditions may be elaborated.

(A) Sometimes, it may happen that bad debts and provision for bad and doubtful debts appear in the Trial Balance; as bad debts are given outside the Trial Balance, and a fresh provision for bad debts is required to be made. In such a case, the provision will be calculated in the manner explained above.

This would involve the following steps :

(i) The amount of bad debts given outside the Trial Balance would be added to the bad debts given in the Trial Balance.

(ii) The amount of additional bad debts is deducted from the amount of debtors given in the Trial Balance for calculating the amount of provision to be maintained at the end of the year.

(iii) The additional bad debts would be deducted from the balance of debtors in the Trial Balance. This is done in the inner column of the Balance Sheet before subtracting the amount of provision for bad and doubtful debts for presenting the figure of debtors at the end of the year.

Example

B's Trial Balance contains the following information:

	Rs.	Rs.
Debtors	40,500	
Bad debts	2,000	
Provision for bad and doubtful debts		2,800

A debt of Rs. 500 becomes irrecoverable at the end of the accounting year. It is desired to create a provision of 6% on debtors at the end of the year. Pass the necessary entries and show the relevant accounts.

Solution

A bad debt of Rs 500 has not been recorded in the books since it is given outside the Trial Balance. Therefore, the amount of bad debt of Rs. 500 will be recorded by means of the following entry·

Bad debts	500	
Debtors		500
(Amount of bad debts recorded)		

Now the bad debts account will be closed by transferring its balance to the Provision for Bad and Doubtful Debts Account The entry will be:

Provision for Bad and Doubtful Debts	2,500	
Bad debts		2,500
(Bad debts transferred to the Provision for Bad and Doubtful Debts Account)		

Provision for the current year will be created by passing the following entry:

Profit and Loss Account	2,100	
Provision for bad and doubtful debts		2,100
(Provision for bad debts created)		

The relevent account will appear as follows:

Dr. Debtors Account Cr.

	Rs		Rs.
Balance b/d	40,500	Bad debts	500
		Balance c/d	40,000
	40,500		40,500
Balance b/d	40,000		

Dr Bad Debts Account Cr

	Rs.		Rs
Balance c/d	2,000	Provision for bad and doubtful debts	2,500
Debtors	500		
	2,500		2,500

Dr. Provision for Bad and Doubtful Debts Account Cr.

	Rs.		Rs
Bad debts	2,500	Balance b/d	2,800
Balance c/d	2,400	Profit and Loss Account	2,100
	4,900		4,900
		Balnce b/d	2,400

Dr Profit and Loss Account Cr.

	Rs	
Bad debts	2,000	
Add additional bad debts	500	
	2,500	
Add new provision	2,400	
	4,900	
Less old provision	2,800	2,100

Balance Sheet

	Assets	Rs.	Rs
	Debtors	40,500	
	Less bad debts	500	
		40,000	
	Less provision	2,400	37,600

New provision has been calculated as under :

Debtors	40,500
Less bad debts	500
Net debtors	40,000

New provision $= 40{,}000 \times \frac{6}{100} =$ Rs. 2,400

(B) Sometimes, the amount of old provision for bad debts given in the Trial Balance is sufficient to cover the bad debts incurred during the year and the new provision required to be made at the end of the year. In such a case, the amount by which the old provision exceeds the bad debts incurred and the new provision will be shown on the credit side of the Profit and Loss Account, as given below :

Dr			Cr.
	Old provision	---	
	Less bad debts	---	

	Less new provision	---	---

Example

A's Trial Balance contains the following information :

	Rs	Rs.
Bad debts	1,000	
Debtors	40,000	
Provision for bad and doubtful debts		3,5000

It is desired to make a provision for bad and doubtful debts of 5% on debtors at the end of the year. Pass the necessary entries and show how the adjustments would appear in the Final Accounts.

Solution

Provision for bad and doubtful debts	1,000	
Bad debts		1,000
(Transfer to bad debts to the provision for bad and doubtful debts)		
Provision for bad and doubtful debts	500	
Profit and Loss Account		500
(Excess of old provision over bad debts and new provision credited to the P & L Account)		

Profit and Loss Account

Dr		Rs	Cr Rs
	Provision for bad and doubtful debts	3,500	
	Less bad debts	1,000	
		2,500	
	Less new provision	2,000	500

Balance Sheet

	Assets	Rs.	Rs.
	Debtors	40,000	
	Less Provision	2,000	38,000

5.5.7 Provision for Discount on Debtors

A business enterprise allows discount to its customers to encourage prompt payments. Discount likely to be allowed to customers in an accounting year can be estimated and provided for by creating a provision for discount on debtors Provision for discount is made on good debtors which are arrived at by deducting bad debts given outside the Trial Balance and the provision for bad and doubtful debts required to be made at the end of the year.

The following entry is passed to create a

provision for discount on debtors:

Profit and Loss Account	
Provision for discount on debtors	
(Provision for discount on debtors created)	

The accounting treatment of the provision for discount on debtors is the same as that of the provision for bad and doubtful debts.

The provision for discount on debtors is shown by way of deduction from debtors in the Balance Sheet.

Example

A Trial Balance furnishes you the following information:

	Rs
Debtors	40,000
Bad debts	2,000
Discount allowed	1,000

It is desired to create a provision for bad and doubtful debts at 5% on debtors and a provision for discount at 2% on debtors. Pass the necessary entries and show how the adjustments will appear in the Final Accounts.

Solution

Profit and Loss Account	3,000	
Bad debts		2,000
Discount		1,000
(Transfer of bad debts and discount to the P & L Account)		
Profit and Loss Account	2,760	
Provision for bad and doubtful debts		2,000
Provision for discount on debtors		760
(Provision for bad debts and provision for discount created)		

These adjustments will appear in the Profit and Loss Account and Balance Sheet as follows:

Dr Profit and Loss Account Cr

	Rs
Bad debts	2,000
Provision for bad and doubtful debts	2,000
Discount	1,000
Provision for discount on debtors	760

Balance Sheet

Assets		
Debtors	40,000	
Less provision for bad debts	2,000	
	38,000	
Less provision for discount	760	37,240

Example

B's Trial Balance furnishes you the following information:

	Debit Balance Rs	Credit Balance Rs.
Debtors	40,000	
Bad debts	2,000	
Discount allowed	1,000	
Provision for bad and doubtful debts		2,500
Provision for discount on debtors		900

It is desired to create a provision for bad and doubtful debts at 5% on debtors and a provision for discount on debtors at 2% on debtors. Pass the necessary entries and show the relevant account.

How will these adjustments appear in the Final Accounts?

Solution

Provision for bad and doubtful debts	2,000	
Bad debts		2,000
(Bad debts transferred to the provision on bad and doubtful debts)		
Profit and Loss Account	1,500	
Provision for bad and doubtful debts		1,500
(Provision for bad debts created)		
Provision for discount on debtors	1,000	
Discount		1,000
(Amount of discount transferred to the provision for discount on debtors)		
Profit and Loss Account	560	
Provision for discount on debtors		560
(Provision for discount on debtors created)		

Bad Debts Account

Dr.	Rs.		Cr. Rs
Balance b/d	2,000	Provision for bad and doubtful debts	2,000

Discount Account

Dr.	Rs		Cr. Rs.
Balance b/d	1,000	Provision for discount on debtors	1,000

Provision for Bad and Doubtful Debts Account

Dr.	Rs.		Cr. Rs.
Bad debts	2,000	Balance b/d	2,500
Balance c/d	2,000	Profit and Loss Account	1,500
	4,000		4,000
		Balance b/d	2,000

Provision for Discount on Debtors Account

Dr.	Rs.		Cr. Rs
Discount	1,000	Balance b/d	900
Balance c/d	760	Profit & Loss Account	860
	1,760		1,760
		Balance b/d	760

Profit and Loss Account

Dr.	Rs	Rs	Cr.
Bad debts	2000		
Add new provision	2000		
	4000		
Less old provision	2500	1500	
Discount	1000		
Add new provision	760		
	1760		
Less old provision	900	860	

Balance Sheet

	Assets	Rs	Rs.
	Debtors	40,000	
	Less provision for bad debts	2,000	
		38,000	
	Less provision for discount	760	37,240

5.5.8 Provision for Discount on Creditors

A business enterpise may receive cash discount from its creditors while making payment to them. This creates an accounting complication. The complication is that the discount on the creditors at the end of the year would obviously be received in the next accounting year, whereas the discount income, according to accrual accounting, belongs to the current year This is taken care of by making a provision for discount on creditors. For this purpose, a 'Provision for Discount on Creditors' is created.

'Provision for Discount on Creditors' is made by the following entry.

Provision for discount on creditors	
Profit and Loss Account	
(Provision for discount on creditors brought into the account)	

The accounting treatment of the provision for discount on creditors is the same as that of the provision for discount on debtors, except that the adjusting entries are reversed.

The provision for discount on creditors is shown as a deduction from creditors in the Balance Sheet.

Example

Yogesh maintains a provision for bad debts at 5% debtors, provision for discount on debtors at 3% and provision for discount on creditors at 2%.

Balances on 1.1.88 in the provision accounts were as follows:

	Rs.
Provision for bad debts account	5000
Provision for discount on debtors account	2000
Provision for discount on creditors account	1500

Debtors as on December 31, 1988 were Rs. 60,000 after writing off bad debts of Rs. 4000 and allowing discount of Rs 1,500.

Creditors as on December 31, 1988 amounted to Rs. 50,000 Discount received during the year amounted to Rs. 1000.

Prepare the necessary provision accounts and show how they would appear in the Profit and Loss Account and Balance Sheet.

Solution

Dr. Provision for the Bad and Doubtful Debts Account Cr

	Rs		Rs.
Bad debts	4,000	Balance b/d	5,000
Balance c/d (5% on Rs. 60,000)	3,000	P & L Account	2,000
	7,000		7,000
		Balance b/d	3,000

Dr Provision for Discount on the Debtors Account Cr.

	Rs.		Rs.
Discount	1,500	Balance b/d	2,000
Balance c/d (3% on (60,000—3,000))	1,710	Profit and Loss Account	1,210
	3,210		3,210
		Balance b/d	1,710

Dr. Provision for Discount on the Creditors Account Cr.

	Rs.		Rs.
Balanc b/d	1,500	Discount received	1,000
P & L Account	500	Balance c/d (2% on 50,000)	1,000
	2,000		2,000
Balance b/d	1,000		

Dr Profit and Loss Account Cr.

	Rs			Rs.	
Bad debts	4000		Discount received	1000	
Add new provision	3000		Add new provision	1000	
	7000			2000	
Less old provision	5000	2000	Less old provision	1500	500
Discount	1500				
Add new provision	1710				
	3210				
Less old provision	2000	1210			

Yogesh

Balance Sheet as on 31st Dec 1988

Liabilities	Amount		Assets	Amount	
	Rs	Rs		Rs.	Rs
Creditors	50,000		S Debtors	60,000	
Less provision for discount on creditors	1,000	49,000	Less provision for bad and doubtful debts	3,000	
				57,000	
			Less provision for discount on debtors	1,710	55,290

Note: It is not a full Balance Sheet

5.5.9 Interest on Capital

Sometime, interest is paid on the proprietor's capital. Such interest is an expense to the business and is debited to the Profit and Loss Account. The adjusting entry passed for this purpose is as follows:

Interest on Capital	—	
Capital		—
(Interest provided on capital)		

Interest on Capital Account is closed by transferring it to the Profit and Loss Account.

In the Balance Sheet, it will be shown by way of addition to the capital of the proprietor.

5.5.10 Interest on Drawings

As interest is allowed on the proprietor's capital, similarly interest may be charged on drawings made by him. Interest on drawings is a gain to the business. It is adjusted by passing the following adjusting entry :

Drawings
Interest on drawings
(Interest charged on drawings)

Interest on the Drawings Account is closed by transferring it to the Profit and Loss Account.

Interest on drawings will be shown by way of deduction from the capital in the Balance Sheet.

5.5.11 Commission on Profit

Sometimes, a manager employed by a business enterprise may be allowed commission as a percentage of the net profit. Commission as a percentage of the net profit may be before or after charging such commission. In the absence of any information, it is assumed that commission is allowed as a percentage of the net profit before charging such commission.

Suppose the net profit of a business amounts to Rs. 84000 before charging commission The manager is allowed a commission of 5% on the net profit before charging such commission. In this case, his commission would be

$$\frac{5}{100} \text{ X } 84000 \text{ or Rs. } 4200.$$

If, in the above case, the manager is allowed commission on the net profit after charging such commission, the computation of his commission would be as follows:

Let net profit after charging commission be		Rs 100
Commission	Rs 5	(5% of Rs 100)
∴ Net profit before charging commission		Rs. 100+Rs 5 = Rs. 105
Commission payable to the manager	$Rs. \frac{5}{105}$ X 84000 = 4000	

The manager's commission will be adjusted in the books by passing the following entry ·

Manager's commission
Outstanding commission
(Commission payable to the manager provided for)

The manager's commission account will be closed by transferring it to the Profit and Loss Account. The outstanding commission will appear on the liabilities side of the Balance Sheet.

5.6 METHODS OF PRESENTING THE FINAL ACCOUNTS

The Final Accounts, i.e., the Trading Account and Profit and Loss Account and Balance Sheet, can be presented in two ways:

(1) Horizontal form.
(2) Vertical form.

5.6.1. Horizontal Form of Presenting the Final Accounts

Under the horizontal form of presentation, items are shown side by side in the Trading and Profit and Loss Account and Balance Sheet. The horizontal form of presenting the Trading Account, Profit and Loss Account and Balance Sheet is given on pages, 102 and 107 of the simple Final Accounts.

5.6.2 Vertical Form of Presenting the Final Accounts

Under the vertical form of presentation, the Final

Accounts are presented in the form of a statement, with different items being shown one below the other in a purposeful sequence.

Under the vertical presentation, the Trading and Profit and Loss Account will appear as follows:

Income statement for the period ending ——

Particulars		*Details*	*Amount*
			Rs.
Sales (Gross)			---
Less returns		---	---
Net sales			
Cost of Goods sold		---	
Opening stock			
Purchases	---	---	
Less returns	<--	---	
Carriage inwards		---	
Wages		---	
Cost of goods available for sale		---	
Less Closing stock			---
Gross Profit			

Operating Expenses			
(a) Selling Expenses			
Advertising		---	
Discount		---	
Allowances		---	
Bad debts		---	
& Provisions		---	
Carriage outwards		---	
Total selling expenses			---
(b) General and Administration Expenses			
Salaries		---	
Rent & Rates		---	
Insurance		---	
Depreciation		---	
Postage		---	
Repairs		---	
General expenses		---	---
Total operating expenses			---
Net Income from operations			
(Operating Profit)			---
Other Income (Non-operating gains)			
Interest earned		---	
Commission earned		---	
Profit on sale of fixed assets		---	---
Less Deductions (non-operating expenses)			
Interest paid		---	
Loss on sale of fixed assets		---	
Loss by fire		---	---
Net non-operating gains			---
Net Income (Net Profit)			---

Under the vertical presentation, the Balance Sheet will appear as follows

Balance Sheet as on ____________

Particulars	*Details*	*Amount*
		Rs.
Current Assets		
Cash in hand	---	
Cash at bank	---	
Bills receivable	---	
Accrued income	---	
Debtors	---	
Stock	---	
Prepaid expenses	---	
Total current assets		---
Less Current Liabilities		
Bank overdraft	---	
Accrued expense	---	
Bills payable	---	
Trade creditors	---	
Income received in advance	---	
Total current liabilities		---
Net working capital (current assets—current liabilities)		---
Fixed Assets		
Furniture & fixtures	---	
Patents	---	
Plant and Machinery	---	
Building	---	
Land	---	
Goodwill	---	
Total fixed assets		---
Total assets (After payingcurrent liabilities)		---
Capital Employed		
Long-term Liabilities		
Loan	---	
Mortgage	---	
Total long-term liabilities		---
Net assets(being the difference between total assets and long-term liabilities)		---

Particulars		Details	Amount
			Rs
Capital (Proprietor)			
Capital in the beginning			---
Add	Capital introduced during the current year	---	
	Interest on capital, salary, etc	---	
	Profit for the current year	---	
Less	Drawings during the current year	---	
	Interest on drawings	---	
	Loss for the current year	---	
	Total capital of the proprietor at the end of the year		---

Demonstration Problems

(I) The following is the Trial Balance of Mr. Arun as on December 31, 1988

	Debit	*Credit*
	Rs	Rs
Cash in hand	1,500	
Cash at bank	7,000	
Purchases	70,000	
Sales		1,20,000
Returns inwards	600	
Returns outward		700
Wages	10,400	
Power & fuel	7,000	
Carriage outward	3,000	
Carriage inward	4,000	
Stock (January 1,1988)	12,000	
Building	40,000	
Machinery	35,000	
Patents	10,000	
Salaries	14,000	
General expenses	3,000	
Drawings	10,000	
Capital		80,000
Sundry debtors	40,000	
Sundry creditors		60,000
Bills payable		6,800
	2,67,500	2,67,500

He furnishes you the following information :

(i) Closing stock on December 31, 1988, is Rs. 16000.

(ii) Machinery and patents are to be depreciated @ 10% p.a. and 20% p.a. respectively.

(iii) Salaries amounting to Rs. 2000 were unpaid.

(iv) A provision for bad and doubtful debts is to be created to the extent of 5% on debtors.

You are required to pass the necessary adjusting and closing entries and prepare a Trading Account and Profit and Loss Account and the Balance Sheet.

Solution

Adjusting entries

1987 December 31	Depreciation	5,500	
	Machinery		3,500
	Patents		2,000
	(Amount written off as depreciation on machinery @ 10% p.a and on patents @ 20% p.a.)		
1987 December 31	Salaries	2,000	
	Outstanding salaries		2,000
	(Amount of salary unpaid on December 31, 1988)		
"	Profit and Loss Account	2,000	
	Provision for bad and doubtful debts		2,000
	(Amount of provision required to be maintained for bad and doubtful debts)		
"	Closing stock	16,000	
	Trading Account		16,000
	(Amount of stock on hand on December 31, 1988)		

Closing Entries

1987 December 31	Trading Account	1,04,000	
	Stock		12,000
	Purchases		70,000
	Wages		10,400
	Power		7,000
	Carriage inward		4,000
	Returns inward		600
	(The transfer of balances of various accounts to the Trading Account)		
"	Sales	1,20,000	
	Returns outward		700
	Trading Account		1,20,700
	(Transfer of balances of the Sales Account and Returns Outward Account)		
1987 December 31	Trading Account	32,700	
	Profit & Loss Account		32,700
	(Transfer of gross profit to the Profit and Loss Account)		
"	Profit & Loss Account	27,500	
	Carriage outward		3,000
	Salaries		16,000
	General expenses		3,000
	Depreciation		5,500
	(Transfer of various expense accounts to the Profit and Loss Account)		
"	Profit and Loss Account	3,200	
	Capital		3,200
	(Transfer of net profit to the Capital Account)		
"	Capital Account	10,000	
	Drawings Account		10,000
	(Transfer of drawings to the Capital Account)		

Dr. Trading and Profit and Loss Account Cr

for the year ending December 31, 1988

		Rs.			Rs
Opening stock (1 1 88)		12,000	Sales	1,20,000	
Purchases	70,000		Less returns inward	600	1,19,400
Less returns outward	700	69,300			
Wages		10,400	Closing stock		16,000
Power		7,000			
Carriage inward		4,000			
Gross Profit c/d		32,700			
		1,35,400			1,35,400
Depreciation					
Machinery	3,500		Gross Profit b/d		32,700
Patents	2,000	5,500			
Salaries	14,000				
Add outstanding salaries	2,000	16,000			
Carriage outward		3,000			
General expenses		3,000			
Provision for bad & doubtful debts		2,000			
Net profit (transferred to the Capital Account)		3,200			
		32,700			32,700

Arun

Balance Sheet as on December 31, 1988

Liabilities		Rs	*Assets*		Rs
Outstanding expenses			Cash in hand		1,500
Salary		2,000	Cash at bank		7,000
Bills Payable		6,800	S Debtors	40,000	
Sundry creditors		60,000	Less provision for bad and doubtful debts	2,000	38,000
Capital	80,000				
Add Net Profit	3,200		Stock		16,000
	83,200		Patents	10,000	
Less drawings	10,000	73,200	Less depreciation	2,000	8,000
			Machinery	35,000	
			Less depreciation	3,500	31,500
			Building		40,000
		1,42,000			1,42,000

II. The following Trial Balance is extracted from the books of Narinder Singh on December 31, 1988:

	Dr. Rs.	Cr. Rs
Salaries	30,000	
General expenses	7,800	
Taxes and insurance	12,200	
Sundry debtors	41,000	
Stock	40,000	
Purchases	82,000	
Wages	4,000	
Sales		1,50,000
Bank overdraft		10,000
Commission		3,000
Advertising	8,000	
Interest	3,000	
Furniture	10,000	
Building	80,000	
Motor vehicles	60,000	
Capital		1,22,000
Sundry creditors		47,500
Bad debts	2,000	
Provision for bad debts		2,500
Loan		45,000
	3,80,000	3,80,000

The following adjustments are to be made:

(i) Stock on hand on December 31,1988, was estimated to be Rs. 35,000.

(ii) Depreciate :
Building @ 5% p a.
Furniture @ 10% p.a.
Motor vehicles @ 20% p.a.

(iii) Rs. 1500 is due for interest on loan.

(iv) Insurance amounting to Rs. 1200 is prepaid .

(v) One third of the commission received is in respect of work to be done next year

(vi) Write off further Rs. 1000 as bad debts and provision for bad debts is to be made equal to 5% on sundry debtors.

Prepare a Trading and Profit and Loss Account for the year ending December 31, 1988, and a Balance Sheet as on that date.

Solution

Trading and Profit and Loss Account
for the year ending December 31,1988

Dr Cr.

	Rs.		Rs.
Opening stock	40,000	Sales	1,50,000
Purchases	82,000	Closing stock	35,000
Wages	4,000		
Gross profit c/d	59,000		
	1,85,000		1,85,000

Depreciation:			Gross profit b/d		59,000
Building	4,000		Commission	3,000	
Furniture	1,000				
Motor Vechicles	12,000	17,000	Less Commission received		
Interest	3,000		in advance	1,000	2,000
Add Interest Outstanding	1,500	4,500			
			Net loss (Transferred to the		
Taxes & Insurance	12,200		Capital Account)		19,800
Less prepaid	1,200	11,000			
Bad debts	2,000				
Add amount further written off	1,000				
	3,000				
Add new provision	2,000				
	5,000				
Less old provision	2,500	2,500			
Salaries		30,000			
General expenses		7,800			
Advertising		8,000			
		80,800			80,800

Note 1 · Depreciation has been calculated as follows

Building $= 80{,}000 \times \frac{5}{100} =$ Rs 4,000

Furniture $= 10{,}000 \times \frac{10}{100} =$ Rs. 1,000

Motor vehicles $= 60000 \times \frac{20}{100} =$ Rs. 12,000

Note 2 New provision for bad debts has been calculated as under ,

Sundry Debtors	41,000
Less amount further written off as bad debts	1,000
	40,000

Provision for bad debts $= 40{,}000 \times \frac{5}{100} =$ Rs 2000

Narinder Singh
Balance Sheet as on December 31, 1988

Liabiliteis		Rs.	*Assets*		Rs.
Bank overdraft		10,000	Prepaid expenses (insurance)		1,200
Outstanding Exp :			Sundry debtors	41,000	
Interest		1,500	Less bad debts	1,000	
Commission received in advance		1,000			
				40,000	
Sundry creditors		47,500	Less provision for bad debts	2,000	38,000
Loan		45,000			
Capital	1,22,000		Stock		35,000
Less net loss	19,800	1,02,200	Furniture	10,000	
			Less deprecation	1,000	9,000
			Motor vehicles	60,000	
			Less depreciation	12,000	48,000
			Building	80,000	
			Less depreciation	4,000	76,000
		2,07,200			2,07,200

Demonstration Problem II - A

In the above problem, the Final Accounts, prepared in the **vertical form,** will appear as follows:

Income statement
for the year ending December 31, 1988

Particulars		*Amount*	*Amount*
		Rs	Rs.
Sales		1,50,000	
Less returns		Nil	
Net Sales			1,50,000
Cost of Goods Sold			
Opening stock		40,000	
Purchases	82,000		
Less returns	Nil	82,000	
Wages		4,000	
Cost of goods available for sale		1,26,000	
Less closing stock		35,000	91,000
Gross Profit			59,000
Operating Expenses			
Selling Expenses			
Bad debts	2,000		
Add amount further written off	1,000		
Add new provision	2,000		
	5,000		
Less old provision	2,500	2,500	
Advertising		8,000	
Total selling expenses			10,500

Particulars		*Amount*	*Amount*
		Rs.	Rs.
General and Administration expenses			
Salaries		30,000	
General expenses		7,800	
Taxes & Insurance	12,200		
Less prepaid	1,200	11,000	
Depreciation			
Building	4,000		
Furniture	1,000		
Motor vehicles	12,000	17,000	
Total General and Administration Expenses			65,800
Total operating expenses			76,300
Net Loss from operations (Net operating loss)			17,300
Other Incomes (Non-operating gains)			
Commission received	3,000		
Less received in advance	1,000	2,000	2,000
Less Deductions (Non-operating expenses)			
Interest paid	3,000		
Add outstanding	1,500	4,500	4 500
Net non-operating loss			2,500
Net Loss			19,800

Narinder Singh
Balance Sheet as on December 31,1988

Particulars		*Amount*	*Amount*
		Rs	Rs.
Current Asset			
Prepaid expenses—insurance		1,200	
Sundry debtors	41,000		
Less bad debts	1,000		
	40,000		
Less provision	2,000	38,000	
Stock		35,000	
Total current assets			74,200
Less Current Liabilities			
Bank over-draft		10,000	

Particulars		Amount	Amount
		Rs.	Rs
Outstanding expenses —Interest		1,500	
Commission received in advance		1,000	
Sundry creditors		47,500	
Total current liabilities			60,000
Net working capital (current assets—current liabilities)			14,200
Fixed Assets			
Furniture	10,000		
Less depreciation	1,000	9,000	
Motor vehicles	60,000		
Less depreciation	12,000	48,000	
Building	80,000		
Less depreciation	4,000	76,000	
Total fixed assets			1,33,000
Total assets (after paying current liabilities)			1,47,200
Capital Employed			
Long-term liabilities			
Loan		45,000	
Total long-term liabilities			45,000
Net assets (Difference between total assets and long-term liabilities			1,02,200
Capital (Proprietor)			
Capital in the beginning		1,22,000	
Less net loss		19,800	
Total capital of the proprietor at the end of the year			1,02,200

III. The following is the Trial Balance of Anshuman as on December 31,1988

	Debit	*Credit*
	Rs	Rs.
Capital		1,00,000
Drawings	10,000	
Plant and machinery	50,000	
Stock	25,000	
Purchases	90,000	
Returns inward	2,000	
Returns outward		1,000

Furniture & fixtures	10,000	
Freight	2,000	
Rent, rates & taxes	5,000	
Printing and stationery	1,000	
Trade expenses	1,200	
Bad debts	1,500	
Provision for doubtful debts		2,000
Sundry debtors	40,000	
Sundry creditors		30,000
Bills receivable	7,000	
Bills payable		7,700
Discount	1,000	
Wages & salaries	5,000	
Cash in hand	6,000	
Cash at bank	12,000	
Sales		1,28,000
	2,68,700	2,68,700

Additional Information

(i) The closing stock on December 31, 1988, is Rs. 40,000.

(ii) Provision for doubtful debts is to be maintained at 5% on sundry debtors.

(iii) Provide for depreciation on furniture and fixtures and plant and machinery @10% p.a.

(iv) Machinery costing Rs. 20,000 was purchased on July 1, 1988.

(v) A fire occurred on December 23, 1988, and stock of the value of Rs. 7,000 was destroyed. It was fully insured and the insurance company admitted the claim in full.

You are required to prepare a Trading and Profit and Loss Account for the year ending December 31, 1988 and a Balance Sheet as on that date.

Solution

Trading and Profit & Loss Account
for the year ending December 31,1988

		Rs.			Rs
Opening stock		25,000	Sales	1,28,000	
Purchases	90,000		Less returns inward	2,000	1,26,000
Less returns outward	1,000	89,000			
Freight		2,000	Closing stock		40,000
Wages & salaries		5,000	Insurance claim		7,000
Gross profit c/d		52,000			
		1,73,000			1,73,000

		Rs		Rs.
Rent, rates & taxes		5,000	Gross profit b/d	52,000
Printing & stationery		1,000		
Trade expenses		1,200		
Bad debts	1,500			
Add new provision	2,000			
	3,500			
Less old provision	2,000	1,500		
Discount		1,000		
Depreciation ·				
Furniture	1,000			
Plant & machinery	4,000	5,000		
Net profit (transferred to the Capital Account)		37,300		
		52,000		52,000

Anshuman

Balance Sheet as on December 31,1988

Liabilities			*Assets*		
		Rs			Rs
Bills payable		7,700	Cash in hand		6,000
Sundry creditors		30,000	Cash at bank		12,000
Capital	1,00,000		Bills receivable		7,000
Add net profit	37,300		Insurance claim		7,000
	1,37,300		Sundry debtors	40,000	
Less drawings	10,000	1,27,300	Less provision		
			for bad debts	2,000	38,000
			Stock		40,000
			Furniture & fixtures	10,000	
			Less depreciation	1,000	9,000
			Plant & machinery	50,000	
			Less depreciation	4,000	46,000
		1,65,000			1,65,000

Note 1 Depreciation on plant and machinery has been calculated as follows

Balance in the Plant & Machinery Account on January 1,1988

(50,000—20,000) = Rs 30,000

Depreciation on Rs 30,000

@ 10% for 1 year = Rs $30{,}000 \times \frac{10}{100}$ = Rs 3,000

Addition to machinery made on July 1, 1988 20,000

Depreciation on Rs. 20,000 @ 10% p a for 6 months = Rs. $20{,}000 \times \frac{10}{100} \times \frac{1}{2}$ = Rs 1,000

Total amount of depreciation = 3000 + 1000 = 4000

IV. The following is the Trial Balance of Abdul Rehman as on December 31,1988 :

Debit Balances	*Rs.*	*Credit Balances*	*Rs*
Drawings	12,000	Capital	1,00,000
Sundry debtors	70,000	Sundry creditors	85,000
Cash in hand	3,000	Loan	40,000
Interest	2,000	Sales	1,60,000
Stock	40,000	Purchases returns	8,000
Cash at bank	9,000	Discount	2,000
Bad debts	4,000	Bills payable	10,000
Land & building	90,000	Rent received	3,000
Sales returns	7,000	Provision for bad debts	5,000
Purchases	1,20,000		
Carriage outward	2,000		
Carriage inward	3,000		
Establishment charges	14,500		
Rates, taxes & insurance	4,000		
Advertisement	6,000		
General expenses	5,000		
Wages	10,000		
Bills receivable	11,500		
	4,13,000		4,13,000

Additional information

(i) The stock in hand on December 31, 1988, is valued at Rs 60,000.
(ii) Prepaid insurance amounted to Rs. 500
(iii) Depreciate land and building at 5% p.a
(iv) Bad debts provision is to be increased by Rs. 1,000.
(v) Provide for the manager's commission at 5% on the net profits after charging such commission

You are required to prepare the Trading and Profit and Loss Account for the year ending December 31,year 1988, and a Balance Sheet as on that date

Solution

Trading Account
for the year ending December 31, 1988

		Rs			Rs.
Opening stock (1.1.87)		40,000	Sales	1,60,000	
Purchases	1,20,000		Less returns	7,000	1,53,000
Less returns	8,000	1,12,000	Closing stock		60,000
Carriage inward		3,000			
Wages		10,000			
Gross profit c/d		48,000			
		2,13,000			2,13,000

		Rs.		Rs.
Interest		2,000	Gross profit b/d	48,000
Bad debts	4,000		Discount	2,000
Add new provision	6,000		Rent received	3,000
	10,000			
Less old provision	5,000	5,000		
Carriage outward		2,000		
Establishment charges		14,500		
Rates, tax & insurance	4,000			
Less prepaid	500	3,500		
Advertisement		6,000		
General expenses		5,000		
Depreciation		4,500		
Manager's commission outstanding		500		
Net profit (transferred to the Capital Account)		10,000		
		53,000		53,000

Note 1

The manager's commission is calculated as follows :-

Let the net profit after charging the manager's commission be Rs. 100

Commission 5% on the net profit = Rs. 5

Therefore, profit before charging such commission Rs. 100 + Rs. 5 = Rs 105

Actual profit before charging the manager's commission Rs. 53,000 — Rs. 42,500 = Rs. 10,500

Manager's commission Rs 10,500 $\times \frac{5}{105}$ = Rs. 500

Since the manager's commission has not been paid, it will be shown on the liabilites side of the Balance Sheet.

Abdul Rehman

Balance Sheet as on December 31, 1988.

Liabilities			*Assets*		
		Rs.			Rs.
Bills payable		10,000	Cash in hand		3,000
Manager's commission outstanding		500	Cash at bank		9,000
Sundry creditors		85,000	Bills receivable		11,500
Loan		40,000	Prepaid insurance		500
Capital	1,00,000		Sundry debtors	70,000	
Add net profit	10,000		Less provision for bad debts	6,000	64,000
	1,10,000		Stock		60,000
Less drawings	12,000	98,000	Land & building	90,000	
			Less depreciation	4,500	85,500
		2,33,500			2,33,500

V. From the following Trial Balance of Jagdish Narain as on December 31, 1988, prepare the Trading and Profit and Loss Account for the year ending December 31, 1988, and a Balance Sheet as on that date.

	Debit	Credit
	Rs.	Rs.
Capital		1,08,000
Stock	46,800	
Sales & sales returns	8,600	2,89,690
Purchases & purchase returns	2,43,100	5,800
Freight	18,600	
Rent & taxes	5,700	
Salaries & wages	9,300	
Sundry debtors	24,000	
Sundry creditors		14,800
Bank loan at 6%		20,000
Bank interest	900	
Printing & advertising	14,600	
Cash at bank	8,200	
Discount received		3,940
Investment	5,000	
Discount allowed	7,350	
General expenses	3,600	
Bad debts	570	
Insurance	1,600	
Travelling expenses	2,130	
Cash in hand	380	
Machinery	30,000	
Drawings	10,000	
Furniture	1,800	
	4,42,230	4,42,230

Additional information

(i) The stock on December 31,1988, was Rs.80,000.
(ii) 50% of printing and advertising is to be carried forward as a charge in the following year.
(iii) Depreciate furniture by 10% and machinery by 5%.
(iv) Create 5% provision on debtors, 2 ½% provision for discount on debtors and creditors.

Solution

Trading and Profit and Loss Account

for the year ending December 31,1988.

		Rs.			Rs
Opening stock (1 1 1988)		46,800	Sales	2,89,690	
Purchases	2,43,100		Less returns	8,600	2,81,090
Less returns	5,800	2,37,300	Closing stock		80,000
Freight		18,600			
Gross profit c/d		58,390			
		3,61,090			3,61,090

		Rs.		Rs.
Printing & advertising	14,600		Gross profit b/d	58,390
Less amount			Provision for discount	
carried to next year	7,300	7,300	on creditors	370
			Discount received	3,940
Depriciation.				
Machinery	1,500			
Furniture	180	1,680		
Bad debts		570		
Provision for bad debts		1,200		
Provision for discount on debtors		570		
Rent & taxes		5,700		
Salaries and wages		9,300		
Bank interest	900			
Add outstanding	300	1,200		
Discount allowed		7,350		
General expenses		3,600		
Insurance		1,600		
Travelling expenses		2,130		
Net profit(transferred to				
the Capital Account)		20,500		
		62,700		62,700

Jagdish Narain

Balance Sheet as on December 31,1988

Liabilities		Rs.	*Assets*		Rs
Outstanding interest		300	Cash in hand		380
Sundry creditors	14,800		Cash at bank		8,200
Less provision for discount on creditors	370	14,430			
			Sundry debtors	24,000	
			Less provision	1,200	
Bank loan		20,000		22,800	
			Less provision for discount on debtors	570	22,230
Capital	1,08,000				
Add net profit	20,500		Stock		80,000
	1,28,500		Investments		5,000
Less drawings	10,000	1,18,500	Furniture	1,800	
			Less depreciation	180	1,620
			Machinery	30,000	
			Less depreciation	1,500	28,500
			Printing & stationery		7,300
		1,53,230			1,53,230

Note 1. Provision for discount on debtors is calculated as follows:

Sundry debtors	24,000
Less provision for bad debts	1,200
Estimated good debtors	22,800

Required provision for discount on debtors Rs.22,800 $\times \frac{5}{200}$ = Rs.570

Note 2. The Trial Balance shows that bank interest amounting to Rs.900 has been paid, whereas interest on bank loan of Rs 20,000 at 6% p a. amounts to Rs.1,200. It follows, therefore, that interest of Rs.300 is still unpaid on December 31, 1988, and, as such, it hasbeen provided for.

VI. On December 31, 1988, the following Trial Balance was prepared from the books of Mr Reddy

	Debit	Credit
	Rs.	Rs
Sundry debtors	50,000	
Sundry creditors		30,000
Bills receivable	6,000	
Bills payable		10,000
Plant & machinery	80,000	
Loan		30,000
Purchases	1,30,000	
Sales		1,97,000
Land & building	40,000	
Salaries	10,000	
Wages	12,000	
Postage & stationery	1,000	
Carriage	2,000	
Bad debts	1,000	
Provision for bad and doubtful debts		4,000
Stock	30,000	
Office expenses	4,000	
Cash in hand	3,000	
Cash at bank	8,000	
Capital		1,10,000
Rent received		6,000
Drawings	10,000	
	3,87,000	3,87,000

The following adjustments are required to be carried out at the end of the year:

(i) Allow 5% interest on capital.

(ii) Rs. 600 is to be charged as interest on drawings.

(iii) A provision for bad and doubtful debts at 5% on sundry debtors is to be made

(iv) Provide depreciation on machinery and land and building @ 10% p a

(v) Rent received in advance is Rs.1,000

(vi) Closing stock on December 31, 1988, is Rs.40,000.

You are required to prepare the Trading and Profit and Loss Account for the year ending December 31, 1988, and a Balance Sheet as on that date.

Solution

Trading and Profit and Loss Account

for the year ending December 31, 1988.

Dr		Rs			Cr Rs.
Opening stock		30,000	Sales		1,97,000
Purchases		1,30,000	Closing stock (31.12.87)		40,000
Wages		12,000			
Carriage		2,000			
Gross profit c/d		63,000			
		2,37,000			2,37,000
Salaries		10,000	Gross profit b/d		63,000
Postage and stationery		1,000	Rent received	6,000	
Office expenses		4,000	Less rent received		5,000
Interest on capital		5,500	in advance.	1,000	
Depreciation :			Provision for		
Machinery	8,000		bad & doubtful debts	4,000	
Land & building	4,000	12,000	Less bad debts	1,000	
				3,000	
Net profit (transferred to the Capital Account)		36,600	Less new provision	2,500	500
			Interest on drawings		600
		69,100			69,100

Reddy Balance Sheet

as on December 31, 1988

Liabilities		Rs.	*Assets*		Rs.
Bills payable		10,000	Cash in hand		3,000
Sundry creditors		30,000	Cash at bank		8,000
Rent recieved in advance		1,000	Bills receivable		6,000
Loan		30,000	Sundry debtors	50,000	
Capital	1,10,000		Less provision for bad debts	2,500	47,500
Add interest	5,000				
	1,15,500				
Add net profit	36,600		Stock		40,000
	1,52,100				
Less drawings	10,000		Plant & machinery	80,000	
	1,42,100		Less dep reciation	8,000	72,000
Less interest on drawings	600	1,41,500	Land & building	40,000	
			Less depreciation	4,000	36,000
		2,12,500			2,12,500

VII. The following is the Trial Balance of Mr. Smith as on December 31,1988.

	Debit	Credit
	Rs.	Rs
Stock	18,000	
Purchases	60,000	
Wages	8,000	
Salaries	10,000	
Carriage	2,000	
Rent & rates	3,000	
Insurance	2,000	
Machinery	30,000	
Building	40,000	
Sundry debtors	15,000	
Furniture	6,000	
General expenses	1,000	
Cash in hand	2,000	
Bad debts	650	
Cash at bank	5,000	
Sales		1,15,000
Capital		70,000
Sundry creditors		21,000
Drawings	6,000	
Bills payable		84,000
Bills receivable	7,000	
Provision for bad debts		1,000
Provision for discount on debtors		475
Provision for discount on creditors	550	
Discount allowed	545	
Discount received		840
	2,16,745	2,16,745

The following adjustments are to be made at the end of the year

(i) Provision for bad debts is to be maintained at 5% on debtors

(ii) Provision for discount on debtors is to be maintained at 2%

(iii) Provision for discount on creditors is to be maintained at 3%

(iv) Depreciate machinery & building @ 10% p.a and furniture @ 5% p.a.

(v) Stock in hand on December 31, is Rs 23,000.

(vi) Outstanding salaries amounted to Rs 1,000.

You are required to prepare the Trading and Profit & Loss Account for the year ending December 31,1988 and a Balance Sheet as on that date

Solution

Trading and Profit and Loss Account
for the year ending December 31,1988

	Rs		Rs
Opening stock	18,000	Sales	1,15,000
Purchases	60,000	Closing stock	23,000
Wages	8,000		
Carriage	2,000		
Gross profit c/d	50,000		
	1,38,000		1,38,000

		Rs.			Rs.
Depreciation			Gross profit b/d		50,000
Machinery	3,000		Discount received	840	
Building	4,000				
Furniture	300	7,300	Add new provision	630	
Bad debts	650			1,470	
Add new provision	750		Less old provision	550	920
	1,400				
Less old provision	1,000	400			
Discount	545				
Add new provision	285				
	830				
Less old provision	475	355			
Salaries	10,000				
Add outstanding	1,000	11,000			
Rent and rates		3,000			
Insurance		2,000			
General expenses		1,000			
Net profit (transfered to the Capital Account)		25,865			
		50,920			50,920

Smith

Balance Sheet as on December 31,1988

Liabilities			*Assets*		
		Rs			Rs
Outstanding Expenses			Cash in hand		2,000
Salaries		1,000	Cash at bank		5,000
Bills payable		8,430	Bills receivable		7,000
Sundry creditors	21,000		Sundry debtors	15,000	
Less provision for discount	630	20,370	Less provision for bad debts	750	
				14,250	
Capital	70,000		Less provision for discount	285	13,965
Add net profit	25,865				
	95,865		Stock		23,000
Less drawings	6,000	89,865			
			Furniture	6,000	
			Less depreciation	300	5,700
			Machinery	30,000	
			Less depreciation	3,000	27,000
			Building	40,000	
			Less depreciation	4,000	36,000
		1,19,665			1,19,665

VIII. Anil and Vijay are two partners in a business. They share profits and losses in the ratio of 4:3 and have agreed that 5% interest will be credited to their capital accounts from profit prior to division. Their Trial Balance as on December 31,1988 is as follows :

	Debit	*Credit*
	Rs.	Rs.
Stock	30,000	
Purchases	1,20,000	
Sundry debtors	60,000	
Trade expenses	5,000	
Anil's drawings	15,000	
Vijay's drawings	10,000	
Anil's capital		90,000
Vijay's capital		50,000
Sales returns	7,000	
Purchases returns		10,000
Sundry creditors		50,000
Sales		1,85,000
Cash in hand	5,000	
Cash at bank	8,000	
Wages	25,000	
Salaries	12,000	
Repairs	2,000	
Buildings	50,000	
Rent, rates & taxes	4,000	
Plant & machinery	30,000	
Insurance	2,000	
	3,85,000	3,85,000

The following adjustments are to be made at the end of the year:

(i) A bill for repairs for Rs. 500 is due but has not been paid till December 31,1988.

(ii) Wages amounting to Rs 900 are outstanding.

(iii) Insurance unexpired on December 31,1988 is Rs 400.

(iv) Depreciate plant and machinery @ 10% p.a. and building @ 6% p a.

(v) Closing stock on December 31,1988 is Rs. 40,000

You are required to prepare the Trading and Profit and Loss Account for the year ending December 31,1988 and a Balance Sheet as on that date.

Solution

Trading and Profit & Loss Account

for the year ending December 31,1988

		Rs			Rs
Opening Stock		30,000	Sales	1,85,000	
Purchases	1,20,000		Less Returns	7,000	1,78,000
Less returns	10,000	1,10,000	Closing stock		40,000
Wages	25,000				
Add Outstanding wages	900	25,900			
Gross profit c/d		52,100			
		2,18,000			2,18,000

		Rs		Rs
Trade expenses		5,000	Gross profit b/d	52,100
Salaries		12,000		
Repairs	2,000			
Add outstanding bill	500	2,500		
Rent, rates & taxes		4,000		
Insurance	2,000			
Less unexpired insurance	400	1,600		
Depreciation				
Plant & machinery	3,000			
Building	3,000	6,000		
Interest on Capital				
Anil	4,500			
Vijay	2,500	7,000		
Net Profit.				
Anil's Capital Account		8,000		
Vijay's Capital Account		6,000		
		52,100		52,100

Anil and Vijay

Balance Sheet as on December 31,1988

Liabilities			*Assets*		
		Rs			Rs
Outstanding expenses			Cash in hand		5,000
Repairs		500			
Wages		900	Cash at bank		8,000
Sundry creditors		50,000	Unexpired insurance		400
Capital			Sundry debtors		60,000
Anil	90,000				
Add interest	4,500		Stock		40,000
Add net profit	8,000				
	1,02,500		Plant & machinery	30,000	
Less drawings	15,000	87,500	Less depreciation	3,000	27,000
Vijay	50,000		Building	50,000	
Add net profit	6,000		Less depreciation	3,000	47,000
	56,000				
Add interest	2,500				
	58,500				
Less drawings	10,000	48,500			
		1,87,400			1,87,400

SUMMARY WITH REFERENCE TO LEARNING OBJECTIVES

1. Meaning, usefulness and types of Financial Statements

After the agreement of the Trial Balance, a business enterprise proceeds to prepare financial statements. Financial statements are the statements which present periodic reports on the progress of a business enterprise and the results achieved during a given period.

Financial statements include Trading Account, Profit and Loss Account, Balance Sheet and other statements and explanatory notes which form part thereof Information provided by financial statements is useful to management to plan and control the business operations Financial statements are also useful to creditors, shareholders and employees of the enterprise.

2. Meaning, need and technique of preparing the Trading Account

The Trading Account shows the results of buying and selling of goods during a given period The basis for the preparation of the Trading Account is the matching of selling prices of goods and services with the cost of goods and services rendered The need for preparation of the Trading Account is to know the gross profit or gross loss as a result of buying and selling of goods during the accounting period

The Trading Account is debited with the opening stock, net purchases and expenses directly connected with such purchases, while it is credited with the net sales and closing stock For the preparation of the Trading Account, the closing entries are passed to transfer balances of accounts of all the items due to appear therein Gross profit or gross loss shown by the Trading Account is transferred to the Profit and Loss Account

3. Meaning, need and technique of preparing the Profit and Loss Account

The Profit and Loss Account highlights the net profit earned or net loss incurred by the business entity in the course of business operations during a given period

The need for preparing the Profit and Loss Account is to ascertain the net results of business operations during a given period Analysis of the Profit and Loss Account is helpful in controlling expenses which are incurred in running a business enterprise

The Profit and Loss Account shows the items of revenue expenses and losses on the debit side while items of gain and gross profit are shown on the credit side For the preparation of the Profit and Loss Account, closing entries are passed to transfer balances of accounts of items of expenses and gain. Net profit or net loss shown by the Profit and Loss Account is transferred to the Capital Account

4. Meaning, characteristics, need and structure of the Balance Sheet

The Balance Sheet is a statement of assets and liabilities of a business enterprise and shows the financial position at a given date Information contained in a Balance Sheet is true only on that date

The Balance Sheet is a part of the Final Accounts But it is not an account, it is only a statement In a Balance Sheet the totals of assets and liabilities are always equal It portrays the Accounting Equation.

A Balance Sheet has to be prepared to know the financial position of the business, and the nature and values of its assets and liabilities

All the accounts which have not been closed till the preparation of the Trading and Profit and Loss Account are shown in the Balance Sheet. Assets and liabilities shown in the Balance Sheet are marshalled in order of liquidity or order of permanence

5. Difference between the Trading and Profit and Loss Account, Trial Balance and balance Sheet

The Trading and Profit and Loss Account can be distinguished from the Balance Sheet in regard to its objectives, mode of preparation, structure and form Similarly, the Balance Sheet differs from the Trial Balance in respect of objectives, mode of presentation, contents and usefulness

6. Rationale of adjustments

For the preparation of the Final Accounts, it is necessary that all adjustments arising out of the accrual basis of accounting are made at the end of the accounting period. Another important consideration in the preparation of the Final Accounts with adjustments, is the distinction between capital and revenue items Entries which are passed to give effect to these adjustments are known as adjusting entries

7. See treatment of various types of Adjustments on pages 153 and 154.

8. Forms of presentation of the Final Accounts

Presentation of the Final Accounts can be made in two ways—(i) Horizontal form, and (ii) Vertical form In the horizontal form of presentation, the items in the Final Accounts are shown side by side Under the vertical form of presentation, different items are shown one below the other in a purposeful sequence

TERMS USED

Accrued income
Adjusting entries
Adjustments — in the Final
  Accounts rationale of
Bad debts
Balance sheet
Bank overdraft
Bills payable
Bills receivable
Capital
Capital expenditure
Capital receipts
Carriage inward
Carriage outward
Cash at bank
Closing entries
Closing stock
Commission manager's
Creditors sundry
Current assets
Current liabilities
Debtors, sundry
Depreciation
Discount
Cash
Trade
Factory expenses
Final accounts
  Presentation
  Simple
  With adjustments
Financial statements
Fixed assets
Freight-in
Freight-out
Fund flow statement
Gross loss
Gross profit
Grouping
  of assets and liabilities
Horizontal form
Income,
  earned but not received
  received in advance
Income tax
Interest,
  on capital
  on drawings
Long term liabilities
Manufacturing account
Marshalling,
  of assets & liabilities
Net loss
Net profit
Opening stock
Order of liquidity
Order of performance
Outstanding expenses
Profit and Loss Account
Provisions,
  for bad and doubtful debts
  for discount on creditors
Purchases

Treatment of various types of adjustments

Adjustment	*Adjustment Entry*	*Treatment in Trading Account*	*Treatment in Profit & Loss Account*	*Treatment in Balance Sheet*
Outstanding Expenses	Expense Account— Outstanding expense	Added to the respective expense on the debit side	Added to the respective expense on the debit side	Shown on the liabilities side
Prepaid or unexpired expense	Prepaid Expense— Expense	Deducted from the item of expense on the debit side	Deducted from the item of expense on the debit side	Shown on the assets side.
Income earned but not received	Accrued income— Income	—	Added to the item of income on the credit side	Shown on the assets side.
Income received in advance	Income— Income received in advance	—	Deducted from the item of income on the credit side	Shown on the liabilities side.
Depreciation	Depreciation— Asset	—	Shown on the debit side.	Deducted from the value of asset on the assets side.
Provision for bad and doubtful debts	Profit & Loss Account— Provision for bad & doubtful debts	—	Shown on the debit side	Shown by way of deduction from the amount of debtors on the assets side.
Provision for discount on debtors	Profit & Loss Account— Provision for discount on debtors	—	Shown on the debit side	Shown by way of deduction from the amount of debtors.

Adjustment	*Adjustment Entry*	*Treatment in Trading Account*	*Treatment in Profit & Loss Account*	*Treatment in Balance Sheet*
8. Provision for discount on creditors	Provision for discount on the creditors account— Profit and Loss Account	—	Shown on the credit side	Shown by way of deduction from the amount of creditors
9 Interest on capital	Interest on the capital account— capital	—	Shown on the debit side	Added to the capital.
10. Interest on drawings	Drawings— Interest on drawings	—	Shown on the credit side	Shown by way of deduction from capital
11 Manager's commission	Manager's commission— Outstanding commission	—	Appears on the debit side	To be shown as outstanding liability

Purchases returns	Revenue expenditure	Trading Accounts
Rent	Revenue receipts	Valuation of assets
Returns inward	Salaries	Vertical form
Returns onward	Sales	Wages
Revenue expenditure	Sales return	

Objective Type Questions

In each of the following questions tickmark (✓) the correct answer out of the choices given

I. The following items appear in A's Trial Balance
Outstanding Wages Rs 1,500
It will appear in ·
(a) Trading Account ( )
(b) Profit and Loss Account ( )
(c) Balance Sheet ( )

II. Returns inwards are deducted from .
(a) Sales ( )
(b) Purchases ( )
(c) Returns outward ( )

III Income tax paid by Mr A amounts to Rs 2,000
The accounting treatment is ·
(a) To be credited to the Profit and Loss Account ( )
(b) To be ignored altogether ( )
(c) To be deducted from capital ( )
(d) To be debited to the Trading Account ( )

IV B's Trial Balance shows the following item ·
Opening stock Rs 30,000
The accounting treatment is
(a) Debited to the Trading Account ( )
(b) Debited to the Profit and Loss Account ( )
(c) Deducted from the closing stock in the Balance Sheet ( )

V A's Trial Balance contains the following information.
Bad debts Rs 2,000
Provision for Bad debts Rs 2,500
It is desired to make a provision for bad debts of Rs 3,000 at the end of the year.
The amount to be debited to the Profit and Loss Account is ·
(a) Rs 3,000 ( )
(b) Rs 4,500 ( )
(c) Rs 2,500 ( )
(d) Rs 5,000 ( )
(e) Rs 7,500 ( )

VI Mohan's Trial Balance provides you the following information·
Bad debts Rs 800
Provision for bad debts Rs 3,000
It is desired to maintain a provision for bad debts of Rs 2,000
The accounting treatment of these adjustments is ·

(a) Rs 1800 to be debited to the Profit and Loss Account ( )
(b) Rs 200 to be credited to the Profit and Loss Account ( )
(c) Rs 200 to be debited to the Profit and Loss Account ( )
(d) Rs 4,200 to be debited to the Profit and Loss Account ( )

VII. Govind's Trial Balance contains the following information .

Discount allowed	Rs. 500
Provision for discount on debtors	Rs. 1,000

It is desired to make a provision for discount on debtors of Rs 1,700 at the end of the year
The amount to be debited to the Profit and Loss Account is:
(a) Rs 1,200 ( )
(b) Rs 3,200 ( )
(c) Rs 700 ( )
(d) Rs 2,200 ( )

VIII D's Trial Balance contains the following information

Discount received	Rs 1,000
Provision for discount on creditors	Rs 1,500

It is desired to maintain a provision for discount on creditors at Rs 1,000
The amount to be credited to the Profit and Loss Account is .
(a) Rs 1,500 ( )
(b) Rs 3,500 ( )
(c) Rs 1,000 ( )
(d) Rs 500 ( )

IX.

B's capital on January 1,1988	Rs 50,000
Interest on drawings	Rs 2,000
Interest on capital	Rs 5,000
Drawings	Rs 20,000
Profit for the year	Rs 10,000

His capital at the end of the year is ·
(a) Rs 67,000 ( )
(b) Rs 43,000 ( )
(c) Rs 47,000 ( )
(d) Rs 69,000 ( )

X. Yogesh's Trial Balance contains the following information:

Bad debts	Rs 3,000
Provision for bad debts	Rs 4,000
Sundry debtors	Rs 25,000

It is desired to create a provision for bad debts at 10% on sundry debtors at the end of the year.
Sundry debtors will appear in the Balance Sheet at a figure of .
(a) Rs 22,500 ( )
(b) Rs 21,000 ( )
(c) Rs 18,000 ( )
(d) Rs 15,500 ( )
(e) Rs 23,500 ( )

XI. Chetan's Trial Balance contains the following information :

Bad debts	Rs 4,000
Discount allowed	Rs 2,000

Provision for discount on debtors	Rs	2,200
Provision for bad debts	Rs	4,500
Sundry debtors	Rs	50,000

At the end of the year, it is desired to maintain a provision for bad debts at Rs 4,000 and provision for discount on debtors at Rs 2,000

Sundry debtors will appear in the Balance Sheet at a figure of :

(a) Rs 44,000 ( )

(b) Rs 38,000 ( )

(c) Rs 44,700 ( )

(d) Rs 31,300 ( )

XII B's Trial Balance as on December 31,1988, contains the following information

Bank loan Rs 50,000

(12% rate of interest)

Interest paid Rs 5,000

Interest debited to the Profit and Loss Account is .

(a) Rs 6,000 ( )

(b) Rs 5,000 ( )

(c) Rs 5,500 ( )

(d) Rs 1,000 ( )

Essay Type Questions

1 What are Financial Statements ? What information do they provide ?

2. What is a Trading Account ? Explain the technique of preparing a Trading Account

3. What are closing entries ? Give four examples of closing entries ?

4. What is a Balance Sheet ? What are its characteristics ? What is the need of preparing a Balance Sheet ?

5. Explain the rationale of preparing a Balance Sheet How does it differ from a Trial Balance ?

6. What do you understand by 'Grouping and marshalling of Assets and Liabilities' ? Explain the ways in which a Balance Sheet may be marshalled

7. Distinguish between
   (i) Capital and Revenue Expenditure
   (ii) Capital and Revenue Receipts

8. Explain the rationale of making adjustments at the time of preparing the Final Accounts ? Mention any three important adjustments that are made for the preparation of the Trading and Profit and Loss Account.

9. State whether the following expenditure is capital or revenue and why ? Give reasons for your answers :
   (a) Expenditure incurred on repairs and whitewashing at the time of purchase of an old building in order to make it usable.
   (b) Expenditure incurred to provide one more exit in a cinema hall in compliance with a government order.
   (c) Registration fees paid at the time of purchase of a building.
   (d) Expenditure incurred in the maintenance of a tea garden which will produce tea after four years
   (e) Depreciation charged on a plant.
   (f) The expenditure incurred in erecting a platform on which a machine will be fixed.
   (g) Advertising expenditure, the benefits of which will last for four years.

EXERCISES

Simple Final Accounts

I The Trial Balance of Mr Brown shows the following balances on December 31,1988

Debit Balances	*Rs*
Purchases	70,000
Sales returns	5,000
Opening stock	20,000
Discount allowed	2,000
Bank charges	500
Salaries	4,500
Wages	5,000
Freight-in	4,000
Freight-out	1,000
Rent, Rates & Taxes	5,000
Advertising	6,000
Cash in hand	1,000
Plant & Machinery	50,000
Sundry debtors	60,000
Cash at bank	7,000
	2,41,000

Credit Balances	
Capital account	56,000
Sales	1,50,000
Purchase returns	4,000
Discount received	1,000
Sundry creditors	3,000
	2,41,000

The closing stock was valued at Rs 30,000. You are required to prepare the Trading and Profit and Loss Account for the year ending December 31,1988, and the Balance Sheet as on that date.

II. From the following Trial Balance extracted from the books of Mohinder Singh, prepare the Trading and Profit and Loss Account for the year ending December 31,1988 and the Balance Sheet as on that date

	Debit balances	Credit balances
	Rs	Rs
Capital		1,89,000
Drawings	20,000	
Plant and Machinery	80,000	
Sundry debtors	70,000	
Sundry creditors		50,000
Purchases	1,10,000	
Purchases returns		7,000
Sales		2,20,000
Sales returns	10,000	
Wages	40,000	
Cash in hand	5,000	
Cash at bank	10,000	
Salaries	30,000	
Repairs	8,000	
Stock	45,000	
Rent	10,000	
Manufacturing expenses	7,000	
Bills receivable	12,000	
Bills payable		20,000
Bad debts	5,000	
Carriage	9,000	
Furniture	15,000	
	4,86,000	4,86,000

Closing stock was valued at Rs 50,000.

III The following balances were extracted from the books of Mr Brijesh Chandra on December 31,1988

	Debit Balances	Credit Balances
	Rs	Rs
Capital		1,41,000
Building	80,000	
Machinery	70,000	
Furniture	15,000	
Stock	50,000	
Power	10,000	
Wages	70,000	
Carriage	8,000	
Rent & rates	12,000	
Insurance	5,000	
Salaries	35,000	

Bank charges	1,000	
Income tax	2,000	
Bad debts	5,000	
Commission received		9,000
Purchases	1,50,000	
Sales		3,40,000
Bills receivable	20,000	
Bills payable		30,000
Bank overdraft		20,000
Cash in hand	2,000	
Purchases returns		10,000
Sales returns	15,000	
	5,50,000	5,50,000

The closing stock was valued at Rs 60,000 You are required to prepare the Trading Account and Profit and Loss Account for the year ending December 31, 1988, and the Balance Sheet as on that date

IV The following Trial Balance is extracted from the books of Rameshwar Prasad on December 31, 1988

Debit Balances	*Rs*
Building	50,000
Furniture & fittings	10,000
Bad debts	2,500
Sundry debtors	50,000
Stock (January 1, 1988)	40,000
Purchases	1,20,000
Sales returns	5,000
Advertising	9,000
Interest	5,000
Cash in hand	2,000
Taxes and insurance	4,000
General charges	3,000
Salaries	11,500
Bills receivable	9,000
Cash at bank	5,000
	3,26,000

Credit Balances	*Rs*
Capital	60,000
Bills payable	7,000
Sundry creditors	30,000
Sales	2,20,000
Purchases returns	4,000
Commission	5,000
	3,26,000

Closing stock on December 31, 1988, was Rs.20,000. From the above, prepare the Trading and Profit and Loss Account for the year ending December 31, 1988, and the Balance Sheet as on that date.

V. The Trial Balance of Mr. Chetan as on December 31, 1988, revealed the following balances:

Debit Balances	*Rs*
Plant & machinery	90,000
Purchases	2,00,000
Sales returns	10,000
Opening stock	70,000
Bank charges	2,000
Sundry debtors	80,000
Salaries	40,000
Wages	50,000
Carriage inward	10,000
Carriage outward	8,000
Rent, rates & taxes	12,000
Advertisement	15,000
Cash in hand	5,000
Discount	6,000
Furniture	20,000
Building	80,000
	6,98,000

Credit Balances	*Rs*
Capital	1,80,000
Sales	3,70,000
Purchase returns	20,000
Discount	10,000
Sundry creditors	90,000
Bank overdraft	20,000
Outstanding wages	8,000
	6,98,000

The closing stock was valued at Rs 80,000. Prepare the Trading and Profit and Loss Account for the year ending December 31, 1988, and the Balance Sheet as on that date

Final Accounts with Adjustments

I From the following Trial Balance, prepare the Trading and Profit and Loss Account for the year ending December 31, 1988, and the Balance Sheet as on that date

	Debit Balances	*Credit Balances*
	Rs	Rs
Salaries	25,000	
Taxes and insurance	6,000	
Cash in hand	5,000	
General expenses	7,000	
Furniture	15,000	
Scooter	8,000	
Building	50,000	
Capital		90,000
Bad debts	4,000	
Machinery	68,000	
Provision for bad debts		5,000
Debtors	80,000	
Creditors		90,000
Opening stock	40,000	
Purchases	1,00,000	
Sales		2,10,000
Bank overdraft		20,000
Returns	10,000	15,000
Advertising	14,000	
Interest	5,000	
Commission		7,000
	4,37,000	4,37,000

The following adjustments are to be made :

(1) Stock on December 31, 1988, was Rs.50,000.
(2) Depreciate building at 5%, furniture and machinery at 10% and scooter at 20%.
(3) Rs. 1000 is due for interest on overdraft.
(4) Insurance amounting to Rs.1,000 is prepaid.
(5) Provision for bad debts is to be maintained at 5% on debtors.

II The following is the Trial Balance of Mr Ashoka as on December 31, 1988

	Debit Balances	*Credit Balances*
	Rs	Rs.
Land & building	70,000	
Plant & machinery	60,000	
Loose tools	10,000	

Bills receivable	15,000	
Opening stock	50,000	
Purchases	1,40,000	
Sales		3,00,000
Wages	40,000	
Carriage	5,000	
Salaries	25,000	
Rent & rates	5,000	
Discount allowed	4,000	
Cash at bank	7,000	
Cash in hand	1,000	
Debtors	80,000	
Bad debts	4,000	
Furniture	20,000	
Advertising	8,000	
Returns	15,000	12,000
Capital		1,50,000
Creditors		97,000
	5,59,000	5,59,000

Adjustments

(i) Closing stock on December 31,1988, was valued at Rs.70,000
(ii) Depreciate plant and machinery at 10%, loose tools at 20%, furniture at 10% and land and building at 5%.
(iii) Make a provision for discount on debtors @ 2% and a provision for bad and doubtful debts at 5% on debtors
(iv) Outstanding wages were Rs 2000

III. From the following balances for the year ending December 31, 1988, and additional information, prepare the Trading and Profit and Loss Account and Balance Sheet of M/s Paul & Sons.

	Debit Balances	*Credit Balances*
	Rs.	Rs
Capital		57,000
Purchases	90,000	
Purchases returns		5,000
Sales		1,70,000
Sales returns	2,000	
Building	50,000	
Opening stock	30,000	
Debtors	50,000	
Creditors		40,000
Furniture	15,000	
Wages	20,000	

Rent	5,000	
Sales tax payable		6,500
Commission		4,000
Insurance	3,000	
Salaries	10,000	
Bad debts	1,500	
Provision for bad debts		3,000
Cash in hand	1,000	
Cash at bank	8,000	
	2,85,500	2,85,500

Additional information

(1) Closing stock was valued at Rs 20,000
(2) Provide depreciation on building @ 5% p a and furniture @ 10% p a
(3) Further bad debts Rs 1000
(4) Make provision for bad debts at 5%

IV From the following Trial Balance extracted from the books of Narendra Kumar, prepare the Trading and Profit and Loss Account for the year ending December 31,1988, and a Balance Sheet as on that date

	Debit Balances	*Credit Balances*
	Rs.	Rs
Capital		81,000
Drawings	10,000	
Plant & machinery	60,000	
Debtors	40,000	
Creditors		45,000
Purchases & sales	80,000	1,40,000
Returns	4,000	5,000
Wages	15,000	
Cash in hand	1,000	
Cash at bank	6,000	
Salaries	10,000	
Repairs	4,000	
Rent	4,500	
Stock	20,000	
Manufacturing expenses	5,000	
Bills receivable	10,000	
Bad debts	1,000	
Provision for bad debts		1,500
Carriage	2,000	
	2,72,500	2,72,500

The following adjustments are made .

(1) Closing stock was valued at Rs.30,000

(2) Depreciate plant and machinery @ 10% p.a

(3) Allow interest on capital @ 5% p.a.

(4) Rent paid in advance Rs.500

V The following balances were extracted from the books of Chand Ram on December 31, 1988.

Debit Balances	Rs	*Credit Balances*	Rs
Drawings	20,000	Capital	1,00,000
Purchases	1,30,000	Sales	2,50,000
Sales returns	20,000	Purchases returns	15,000
Stock	50,000	Provision for bad debts	4,000
Sundry debtors	70,000	Sundry creditors	80,000
Rates and insurance	2,000	Bills payable	10,000
Discount	1,000	Rent received	5,000
Wages	40,000	Outstanding salaries	3,000
Building	60,000		
Carriage	5,000		
Office expenses	5,000		
Printing and stationery	2,000		
Postage and telegrams	1,000		
Cash in hand	1,000		
Cash at bank	5,000		
Furniture	10,000		
Salaries	22,000		
Bills receivable	20,000		
	4,67,000		4,67,000

Adjustments

(1) Closing stock was valued at Rs 40,000

(2) Additions to building amounting to Rs 10,000 were made on June 30,1988. This has been recorded in the book. Depreciate buildings @ 10% p.a

(3) Increase the bad debts provision by Rs.1000

You are required to prepare the Trading and Profit and Loss Account for the year ending December 31,1988, and the Balance Sheet as on that date

VI The following is the Trial Balance of Mr Gopal Das as on December 31,1988.

	Debit Balances	*Credit Balances*
	Rs	Rs
Purchases	1,12,000	
Returns inward	10,000	
Rent	27,500	
Wages	40,000	
Salaries	38,500	
Office expenses	4,000	
Insurance (paid for the year ending March 31,1989)	4,800	
Stock	35,000	
Plant & machinery	60,000	
Furniture	20,000	
Cash in hand	4,000	
Cash at bank	9,000	
Sundry debtors	80,000	
Capital		1,50,000
Loan		28,000
Sales		2,00,000
Sundry creditors		50,000
Outstanding wages		4,000
Returns outward		12,000
Bad debts	3,200	
Provision for bad debts		4,000
	4,48,000	4,48,000

The following adjustments are to be made

(1) Closing stock was valued at Rs 40,000

(2) Maintain provision for bad debts at 6% on sundry debtors.

(3) Depreciate plant & machinery @10% p.a and furniture @ 20% p a.

(4) Expenses for rent and salaries are uniform throughout the year and those for December have not been paid.

You are required to prepare the Trading and Profit and Loss Account for the year ending December 31,1988, and a Balance Sheet as on that date

VII. The following is the Trial Balance of Anwar Ali as on December 31,1988.

Debit Balances	Rs.	*Credit Balances*	Rs
Plant & machinery	1,00,000	Sales	4,00,000
Furniture & fixtures	30,000	Bills payable	30,000
Stock	80,000	Sundry creditors	66,000
Debtors	90,000	Provision for bad debts	5,000
Cash in hand	10,000	Returns outward	10,000
Cash at bank	20,000	Discount received	6,000
Wages	70,000	Capital	1,70,000

Purchases	1,80,000	
Bills receivable	12,000	
Returns inward	20,000	
Drawings	30,000	
Rent	15,000	
Factory lighting	5,000	
Telephone charges	2,000	
Insurance	4,000	
Advertising	10,000	
Bad debts	4,000	
Discount allowed	5,000	
	6,87,000	6,87,000

The following adjustments are to be made

(1) Closing stock was valued at Rs 70,000

(2) Rent due but not paid Rs.1,000.

(3) Unexpired insurance Rs.500

(4) Provision for bad and doubtful debts to be increased to Rs 6000.

(5) Provide for 2% discount on debtors and creditors

You are required to prepare the Trading and Profit and Loss Account for the year ending December 31,1988, and the Balance Sheet as on that date

VIII. Mohan Singh has extracted the following trial balance from his books as on March 31, 1989

	Debit Balances	*Credit Balances*
	Rs.	Rs.
Bills receivable	16,000	
Cash	7,000	
Petty cash	1,000	
Land & buildings	30,000	
Opening stock	40,000	
Salaries	12,000	
Debtors	50,000	
Wages	40,000	
Cash at bank	12,000	
Capital		1,00,000
Rent	8,000	
Office lighting	4,000	
Power	8,000	
Advertising	9,000	
Creditors		70,000
Purchases	2,00,000	
Postage and telegrams	1,000	
Sales		3,10,000
Discount	7,000	
General expenses	5,000	
Drawings	30,000	
	4,80,000	4,80,000

You are required to prepare the Trading and Profit and Loss Account for the year ending March 31,1989, and the Balance Sheet as on that date, after taking into account the following additional information

(1) Closing stock at market price as on March 31,1989, was Rs 80,000 However, its cost was Rs 60,000.

(2) Allow interest on capital at 5% p a

(3) Depreciate land and building by 10%

(4) Write off bad debts amounting to Rs 5,000

(5) Create a provision for bad debts at 10% of debtors.

(Hint: Closing stock is valued at cost following the principle cost or market price, whichever is less)

IX. The following balances have been extracted from the books of Quality Stores as on December 31,1988.

	Debit Balances	Credit Balances
	Rs	Rs
Furniture	15,000	
Capital		1,00,000
Cash in hand	4,000	
Opening stock	50,000	
Purchases	1,60,000	
Fixed deposit with bank	10,000	
Drawings	30,000	
Bad debts	6,000	
Provision for bad debts		7,000
Salaries	30,000	
Carriage inwards	10,000	
Insurance	6,000	
Rent	13,000	
Debtors	90,000	
Sales		3,00,000
Creditors		50,000
Advertising	20,000	
Printing and stationery	6,000	
General expenses	7,000	
	4,57,000	4,57,000

The following adjustments are to be made .

(1) Closing stock was valued at Rs.40,000

(2) Depreciate furniture by 20% p a

(3) Rent paid for the accounting year ending December 31,1988, amounted to Rs.12,000.

(4) Increase the provision for bad debts by Rs 1,000

(5) 50% of the expenses for advertising are to be carried forward to the next year.

X An inexperienced clerk, Shiv Ram prepared the following Trial Balance as on December 31,1988.

Credit Balances	Rs	*Debit Balances*	Rs.
Capital	68,000	Building	50,000
Loan at 10%	60,000	Furniture	10,000
Creditors	30,000	Plant	40,000
Bills receivable	12,000	Debtors	50,000
Returns outward	6,000	Bills payable	11,000
Carriage outward	4,000	Commission received	5,000
Sales	1,50,000	Opening stock	30,000
		Wages	15,000
		Salaries	12,000
		Rent & rates	10,000
		Printing & stationery	4,000
		Purchases	80,000
		Interest on loan (Paid upto 31st October)	5,000
		Returns inward	5,000
		Carriage inward	3,000
	3,30,000		3,30,000

Prepare the correct Trial Balance, Trading and Profit and Loss Account for the year ending December 31,1988, and the Balance Sheet as on that date after taking the following adjustments into account.

(1) Closing stock was valued at Rs 40,000

(2) Depreciate building and furniture by 10% and plant by 15%.

(3) Outstanding salaries amounted to Rs 1,000.

(4) Write off bad debts of Rs 1,000.

XI. The following is the Trial Balance of Radha Krishna on December 31,1987.

	Debit Balances Rs	*Credit Balances* Rs
Cash in hand	1,000	
Cash at bank	17,000	
Sundry debtors	56,000	
Stock (1.1.87)	41,000	
Furniture & equipment	30,000	
Land & building	1,20,000	
Sundry creditors		48,000
Loan on mortgage		50,000
Capital		1,00,000
Drawings	12,000	
Sales		4,50,000
Sales returns & allowances	5,000	
Rent receivable		6,000
Purchases	2,80,000	

Purchases returns & allowances		4,000
Transportation inward	4,000	
Salaries	54,000	
Advertising	20,000	
Interest on loan	3,000	
Insurance premium	8,000	
Utilities expenses	7,000	
	6,58,000	6,58,000

Adjustments

(1) Insurance premium is for the year ending March 31,1988

(2) Depreciation to be provided on furniture and equipment at 5% and on land and building at 2%

(3) Interest on loan is 12% p a and is unpaid for six months

(4) Stock in hand on December 31,1987, is Rs 24,000

XII From the following Trial Balance of Aziz Ahmed, prepare the Trading and Profit and Loss Account and Balance Sheet as on December 31,1987

Balances	Rs	*Credit Balances*	Rs
Cash in hand	950	Sales	1,38,700
Bills receivable	7,600	Return outward	2,800
Purchases	74,500	Trade creditors	12,300
Opening stock	14,450	Rent from sublet	6,500
Return inwards	1,700	Discount	800
Carriage	3,500	Capital	50,000
Wages	8,000	Bank overdraft	10,000
Drawings	24,000	Bad debts reserve	700
Power	3,600		
General expenses	4,200		
Salaries	14,000		
Debtors	16,800		
Manufacturing expenses	4,200		
Insurance	1,800		
Rent	11,000		
Plant & machinery	24,000		
Furniture & fittings	7,000		
Bad debts	500		
	2,21,800		2,21,800

The following adjustments are necessary

1. The closing stock was Rs.8,700.
2. Rent is paid for 11 months but is received for 13 months
3. Insurance is paid for the year ending March 31,1988. Further, bad debts amounted to Rs.800 and provision is made at 5% on debtors for doubtful debts
4. Interest on bank overdraft was outstanding Rs 250

XIII. From the following Trial Balance and the accompanying additional data of Ashok prepare Trading and Profit and Loss Account for the year ending March 31, 1987 and a Balance Sheet as on that date

	Debit Balances	*Credit Balances*
	Rs.	Rs.
Cash at bank	22,900	
Accounts receivable	40,650	
Merchandise inventory	61,100	
Stores equipment	38,500	
Office equipment	20,800	
Accumulated depreciation		
Stores equipment		12,250
Office equipment		9,250
Accounts payable		38,600
Salaries	32,000	
Capital		85,000
Drawings	24,000	
Sales		3,57,000
Sales & returns	4,120	
Purchases	2,12,400	
Purchase returns		2,720
Delivery expenses	12,200	
Selling expenses	1,200	
Office expenses	18,000	
Rent expenses	8,400	
Insurance expenses	7,750	
	5,04,820	5,04,820

Adjustments

1. Merchandise inventory on 31 3.1987 is Rs 56,300
2. Depreciation for current year—Stores equipment Rs 3,100
   Depreciation for current year—Office equipment Rs 2,700
3. Insurance prepaid is Rs 2,750.
4. Rs 1,600 for rent is due but not paid.
5. A typewriter of the value of Rs 5,000 purchased during the year is included in the purchases

XIV. From the following ledger balances extracted at the close of a trading year ended December 31,1986, prepare a Trading and Profit and Loss Account and Balance Sheet as on that date after giving effect to the under mentioned adjustments:

	Rs		Rs
Capital Account (1 1 86)	80,000	Printing and stationary a/c	1,250
Stock Account (1 1 86)	18,000	Rates & taxes a/c	3,350
Net purchases	1,20,000	Travelling expenses a/c	750
Net sales	1,80,000	Business premises	55,000
Carriage outward account	4,500	Furniture and fixtures	12,500
Wages account	6,300	Bills receivable	13,500
Salaries account	15,500	Bills payable a/c	12,500
Rent account	11,600	Sundry debtors	30,000
Freight inward	4,400	Sundry creditors	25,800

Fire insurance premium	1,800	Packing machinery	24,500
Bad debts account	2,100	Loan a/c	50,000
Discount a/c (Dr)	500	Cash in hand	1,250
		Cash at bank	3,500
		Proprietors' withdrawals	18,000

Adjustments to be made for the current period are

1 Stock in hand on December 31,1986 Rs 27,000
2. Fire insurance premiums include Rs 600 paid on July 17,1986, to run for one year from July 1,1986 to June 30,1987.
3. Depreciate Business premises by 5% Furniture and fixtures by 10% and packing machinery by 10%
4 Further bad debts amounted to Rs 1,000 Create a reserve on debtors for doubtful debts at 5% and for discount at 2%.
5. Create a reserve on creditors for discounts at 2%.
6 Interest on loan for one year has accrued at 12%.

ANSWERS

Objective Type Questions

I	(c)	Balance sheet
II	(a)	Sales
III	(c)	To be deducted from the capital in the Balance Sheet
IV	(a)	Debited to the Trading Account
V	(c)	Rs 2,500
VI	(b)	Rs 200 to be credited to the Profit and Loss Account
VII	(a)	Rs 1,200
VIII	(d)	Rs 500
IX	(b)	Rs 43,000
X	(a)	Rs 22,500
XI	(a)	Rs 44,000
XII	(a)	Rs 6,000

Essay Type Questions

IX	(a)	Capital
	(b)	Revenue
	(c)	Capital
	(d)	Capital
	(e)	Revenue
	(f)	Capital
	(g)	Deferred Revenue

Simple Final Accounts

I	Gross profit	Rs 80,000
	Net profit	62,000
	Balance Sheet	1,48,000

II	Gross profit	56,000
	Net profit	3,000
	Balance Sheet	2,42,000
III	Gross profit	1,07,000
	Net profit	58,000
	Balance Sheet	2,47,000
IV	Gross profit	79,000
	Net profit	49,000
	Balance Sheet	1,46,000
V	Gross profit	1,30,000
	Net profit	57,000
	Balance Sheet	3,55,000

Final Accounts with Adjustments

I	Gross profit	1,25,000	Net profit	59,600
	Balance Sheet	2,59,600		
II	Gross profit	1,30,000	Net profit	64,980
	Balance Sheet	3,13,980		
III	Gross profit	53,000	Net profit	33,050
	Balance Sheet	1,36,550		
IV	Gross profit	49,000	Net profit	19,950
	Balance Sheet	1,40,000		
V	Gross profit	60,000	Net profit	22,500
	Balance Sheet	1,95,500		
VI	Gross profit	55,000	Net loss	38,600
	Balance Sheet	1,99,400		
VII	Gross profit	1,25,000	Net profit	89,140
	Balance Sheet	3,24,820		
VIII	Gross profit	82,000	Net profit	18,500
	Balance Sheet	1,63,500		
IX	Gross profit	1,20,000	Net profit	39,000
	Balance Sheet	1,59,000		
X	Corrected Trial Balance Total Rs 3,30,000			
	Gross profit	63,000	Net profit	18,000
	Balance Sheet	1,89,000		
XI	Gross profit	1,48,000	Net profit	57,000
	Balance Sheet	2,46,100		
XII	Gross profit	40,250	Net profit	13,850
	Balance Sheet	63,900		
XIII	Gross profit	1,43,400	Net profit	58,400
	Balance Sheet	1,59,600		